83-1250

No. 83-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

KEWANEE OIL COMPANY,

Petitioner,

v.

BARBARA HOLMES, Executor of the Estate of Elmer Holmes; EVELYN WOLKINS; and SAM BAIER, *et al.*,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF KANSAS

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January 1984

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QUESTION PRESENTED

Petitioner is a producer of natural gas and respondents are landowners. They are parties to natural gas leases that provide for the payment to the landowners of royalties that are a fraction of the market value of the gas sold by the producer. Since 1978, a ceiling on the price that petitioner may charge for natural gas sold to its intrastate customer has been imposed by a section of the Natural Gas Policy Act of that year.

The question presented is whether, consistently with the Natural Gas Policy Act and the Supremacy Clause, a state may, for the purpose of calculating royalties, determine that the market value of the gas produced from the leaseholds is a higher ceiling price prescribed by another section of the Natural Gas Policy Act, a price that petitioner is forbidden by the federal statute to charge.

PARTIES TO THE PROCEEDING

Petitioner is Kewanee Oil Company, a subsidiary of Gulf Oil Corporation, which in turn is a wholly-owned subsidiary of Gulf Corporation. Gulf Corporation's non-wholly owned subsidiaries and affiliates are listed in Appendix H, pp. 46a-48a, *infra.*

Respondents are Barbara Holmes, Executor of the Estate of Elmer Holmes; Evelyn Wolkins; Sam Baier; Bonnie Baier; James H. Trice, Jr., Trustee of the Residuary Trust Established Under the Will of James H. Trice; and LaVon Thompson Hoefle.

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OPINIONS BELOW

The opinion of the Kansas Supreme Court, which also constitutes the judgment herein under Kansas practice, is reported at 233 Kan. 544, 664 P.2d 1335, and is set forth as Appendix A, pp. 1a-13a, *infra*. The opinion of the Kansas District Court is unreported and is set forth as Appendix B, pp. 14a-31a, *infra*.

JURISDICTION

The final judgment of the Kansas Supreme Court (n. 2, *infra*) was entered on June 10, 1983. (App. A, p. 13a, *infra*.) The court denied petitioner's timely motion for rehearing on September 30, 1983. (App. F, p. 39a, *infra*.) On December 20, 1983, Justice White extended the time within which to file a petition for a writ of certiorari to and

including January 28, 1984. The Court's jurisdiction is invoked under 28 U.S.C. § 1257(3).

CONSTITUTIONAL PROVISION AND STATUTE INVOLVED

The United States Constitution, Article VI, Clause 2, provides in pertinent part:

> "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof. . ., shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

Excerpts from the Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432, are reprinted in Appendix G, pp. 40a-45a, *infra*.

STATEMENT

Factual Background

Petitioner Kewanee Oil Company, a subsidiary of Gulf Oil Corporation, produces natural gas in the Medicine Lodge gas field in Kansas pursuant to leases almost all of which were executed before 1950. All of the leases provide for the payment of royalties to the landowners equal to a fraction "of the gross proceeds [from the sale of the gas] at the prevailing market rate." Kewanee is the successor to the interests of the original lessees under the leases. In 1978, Gulf Oil Corporation acquired Kewanee and has taken an assignment of the leases and relevant production contracts since then. In January 1984, in an internal reorganization, Gulf Oil Corporation became a wholly owned subsidiary of Gulf Corporation.

Almost all the natural gas that Kewanee produces from the Medicine Lodge leaseholds has been and is sold to the

Kansas Power & Light Company, which in turn sells it to residential, industrial and commercial customers in Kansas.[1] Before 1978, there was no federal regulation of intrastate sales such as Kewanee's sales to KPL. Since December 1, 1978, the prices for which producers may sell gas to intrastate customers such as KPL have been subject to federal ceilings prescribed by the Natural Gas Policy Act of 1978 ("NGPA"), 15 U.S.C. § 3301 *et seq.* Kewanee's Medicine Lodge gas has been subject to the federal price ceiling established by section 105 of the NGPA, 15 U.S.C. § 3315. (p. 40a, *infra.*) Since December 1, 1978, when federal control of intrastate natural gas prices began, Kewanee has regularly paid royalties based on the highest price at which it believed that it could lawfully sell the gas from the leases on the theory that that price is the "market rate" for its gas.

The Proceedings Below

The respondent landowners initiated these actions in late 1977 and early 1978 alleging that Kewanee had not paid them all that they were entitled to by way of royalties. The Kansas trial court, the Barber County District Court, awarded greatly increased royalties to respondents based on the "highest and best" price paid for natural gas in the Medicine Lodge area for the period July 1972 through October 1981, without regard, after December 1, 1978, for the federal ceiling on the price for which Kewanee could sell the gas produced from the Medicine Lodge leaseholds. The court thus equated the contractual phrase "market rate" with market value and read into the

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[1] Petitioner does not seek review in this Court of the portion of the Kansas court's decision concerning an inconsequential amount of interstate gas that was involved in the dispute below.

latter phrase an inapposite "highest and best" concept favorable to the landowners taken from the laws of eminent domain and property tax assessment. So viewing the case, from the standpoint of the landowners, the court found that the "market rate," after December 1, 1978, was equal to the price ceiling established by section 108 of the Natural Gas Policy Act, 15 U.S.C. § 3318 (p. 42a, *infra*) for so-called stripper-well natural gas. Some stripper-well gas was sold in the Medicine Lodge area but none by Kewanee. The stripper-well price ceiling is significantly higher than the section 105 ceiling applicable to Kewanee's natural gas. The stripper-well rate is an incentive rate designed to encourage producers to maintain the production of wells, typically older wells, that yield low volumes of gas and are therefore relatively uneconomical. None of Kewanee's Medicine Lodge wells was a stripper well within the meaning of section 108.

The Kansas Supreme Court affirmed the trial court's judgment in pertinent part,[2] concluding that, for the pur-

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[2] The Kansas Supreme Court reversed the trial court's grant of prospective relief, which had set royalties based on the 108 price until 1985, when further deregulation is scheduled to occur under the NGPA, and, thereafter, the highest price paid for natural gas in Barber County. The Kansas Supreme Court stated that the market value finding was "factual in nature and not controlling on future cases because the market might fluctuate. However, the principles of law enunciated herein are precedential and thereby controlling." (p. 12a, *infra*.) The supreme court also reversed the trial court's award of prejudgment interest. (p. 12a-13a, *infra*.) With the supreme court's decision, nothing "further remains to be determined by a State court," Radio Station *WOW*, Inc. v. Johnson, 326 U.S. 120, 124 (1945); nothing remains for the trial court except the ministerial excision of the provisions in its original judgment for prospective relief and for prejudgment interest. The judgment of the Kansas Supreme Court is accordingly final. *Id.; see* Cox Broadcasting Corp. v Cohn, 420 U.S. 469 (1975).

pose of computing royalties, federal regulation establishing the maximum price that a producer may receive from its purchaser was "no obstacle" to fixing a higher rate as the "market value" of the gas that it produces and sells. (pp. 7a, 12a, *infra.*)

Kewanee asserted both in the trial court and in the Kansas Supreme Court that, beginning December 1, 1978, the market rate of the gas under respondents' leases could not exceed the NGPA ceiling price at which the gas could be marketed and that, as a matter of federal law, royalties could not lawfully be based on any price above the federally-prescribed ceiling.[3]

REASONS FOR GRANTING THE WRIT

Under its Medicine Lodge gas leases as leases so written have been construed by the Kansas courts,[4] the petitioner Kewanee agreed to pay its lessors royalties based on what it should have gotten in the market for the commodity coming off the leaseholds rather than what it

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[3] The federal question whether the NGPA controlled the royalty obligation under the leases was specifically raised byKewanee before the trial court in a motion to refer issues under Natural Gas Policy Act of 1978 to the Federal Energy Regulatory Commission (Feb. 9, 1981), which was denied (App. C, pp. 32a-34a, *infra*); a motion for partial summary judgment (Nov. 12, 1981), which was denied (App. D, pp. 35a-36a, *infra*); a memorandum brief in support of findings and conclusions; and a motion to set aside findings of fact, to make new and additional findings of fact and conclusions of law, and to alter and amend the judgment entered herein (Feb. 25, 1982), which was denied (App. E, pp. 37a-38a, *infra*). The federal claim was appropriately preserved on appeal to the Kansas Supreme Court.

[4] See Waechter v. Amoco Prod. Co., 217 Kan. 489, 537 P.2d 228 (1975), distinguishing leases that provide for royalties based on the "market rate" or "market value" from leases that provide for royalties based on actual proceeds of sales.

actually got. The Kansas Supreme Court has now proceeded from that construction of the leases and ruled that Kewanee is bound by the relevant term of its leases to pretend that the "market rate" for its commodity—what it should have gotten—is an amount that it could not have gotten by the exercise of the most sagacious business judgment or pursuit of the most aggressive sales strategy. For Kewanee is restricted by federal law in what it can charge for natural gas. Yet, the Kansas court has determined that the market value of the gas on which the royalties payable to its lessors are to be calculated is a price higher than the statutory ceiling that binds Kewanee. The Kansas court has determined that the market rate under Kewanee's leases is another federal statutory ceiling price, applicable to some natural gas but not to the gas that was produced by Kewanee from its leaseholds in the Medicine Lodge field.

Thus, a contractual term that, as construed by the Kansas courts, would protect the lessors from the effects of negligent, mistaken or fraudulent business conduct on the part of their lessee is made, by the further ruling of those courts, into an instrument for oppressing the lessee and awarding a windfall to the lessors. In some circumstances a ruling that had this effect might be passed off as simply misguided, parochial state law, favoring local landowners over producers who may come from outside. But here the Kansas Supreme Court's ruling bumps squarely up against the comprehensive federal regime of regulation of natural gas prices that is embodied in the Natural Gas Policy Act of 1978. In ruling that the applicable federal ceiling prescribed by that statute must be ignored in the calculation of royalties, the Kansas court has decided an important question of federal law. It has decided the question in a way that is inconsistent with decisions of this Court that private natural gas contracts,

including contracts between producers and royalty holders, though generally governed by state law, must yield to supreme federal law as expressed in comprehensive natural gas legislation. It has decided the question in a way that is also in conflict with decisions of the highest courts of other states and of a United States court of appeals keenly attuned to federal natural gas law.

1. Kewanee holds oil and gas leases on a number of tracts in the Medicine Lodge area. Each such lease provides that Kewanee will pay the landowner one-eighth of "the gross proceeds at the prevailing market rate, for all gas used off the premises. . . ." Kewanee sells the natural gas that it has thus acquired the right to produce to the Kansas Power & Light Company. The price of gas under the long-term contract between Kewanee and the utility, which dates back to 1929, is subject to periodic increases negotiated by the parties or fixed by arbitration if the parties cannot agree; they have always agreed.

The Natural Gas Policy Act of 1978 for the first time extended federal price ceilings to intrastate sales of natural gas, such as the sale by Kewanee to KPL. This broadening of federal regulation was intended to eliminate the market distortion that had grown up as a result of the existence of an unregulated intrastate market for natural gas alongside an interstate market regulated by the Federal Power Commission and then the Federal Energy Regulation Commission under the Natural Gas Act of 1938. With the Natural Gas Policy Act Congress undertook to do away with this dual-market structure and the accompanying drain of potential new gas from the regulated interstate market to the unregulated intrastate market; intrastate prices began significantly to exceed the regulated interstate prices in the late 1960's when gas supplies shortened, and the higher price attracted to the

intrastate market gas not already committed to the interstate market. *State of Oklahoma* v. *FERC*, 494 F. Supp. 636, 654-55 (W.D. Okla. 1980), *aff'd*, 661 F.2d 832 (10th Cir. 1981), *cert. denied*, 457 U.S. 1105 (1982); Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 Tex. L. Rev. 101, 120-21 (1980). The Natural Gas Policy Act was also intended to preserve and expand incentives for the production of intrastate as well as interstate gas. *Public Service Comm'n* v. *Mid-Louisiana Gas Co.*, 103 S. Ct. 3024, 3032 (1983) ("[i]n each category of gas, the statute explicitly establishes an incentive pricing scheme"); Note, *supra*, 59 Tex. L. Rev. at 120-21.

The heart of the NGPA is an elaborate system of ceiling prices, applicable to both interstate sales and intrastate sales, set forth in several of its sections. Section 105 of the Act (p. 40a, *infra*) governs Kewanee's gas. It prescribes a ceiling on what a producer can charge for natural gas that was being sold to an intrastate customer on November 9, 1978. In the case of the Kewanee-KPL contract, the ceiling initially under section 105 was the contract price as most recently redetermined before November 9. Under the terms of the contract as it then read, that contract price has never risen to the level of an alternative benchmark prescribed by section 105. Accordingly, the contract price as redetermined periodically has remained the federal ceiling.[5] Because of the parties' understanding of

[5] If, as was true of the Kewanee-KPL contract, an intrastate contract price on November 9, 1978, was lower than the ceiling price established by § 102 of the NGPA (p. 40a, *infra*) for new natural gas, then, under § 105(b)(1), the ceiling at any time thereafter is the lower of (1) the contract price as determined in accordance with the terms of the contract as they read on November 9, and (2) the § 102 price, as escalated for inflation and incentive factors, at the time of the determination.

the effect of the Kansas Natural Gas Price Protection Act, enacted in 1979, on the redetermination clause of their contract, the contract price resulting from periodic redetermination has been limited to the ceiling established by section 109 of the NGPA, 15 U.S.C. § 3319 (p. 43a, *infra*), a residual, catch-all price provision to which the Kansas statute refers. Kan. Stat. Ann. §§ 55-1403, 1404, 1405.[6]

In October 1981, the Kewanee-KPL contract price, which in the parties' view was at its highest permissible level, was $2.08 per million Btu's. That is far below the price that the Kansas Supreme Court, ignoring the applicable ceiling, determined to be the market value of Kewanee's gas. That fictitious value, as we have said, was the price provided for in section 108 of the NGPA, an incentive price applicable only to stripper wells—wells that produce less than a specified volume per day. In October 1981 the stripper-well price was $3.116 per million Btu's, half again as much as the $2.08 ceiling.

2. The Kansas court's blithe observation that federal regulation of the price of natural gas constituted "no obstacle" to its thus basing royalties on a price that Kewanee is forbidden to charge (pp. 7a, 12a, *infra*) contravenes decisions of this Court establishing the duty of

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[6] Leave to enact a statute such as the Kansas Natural Gas Price Protection Act is granted to the states by § 602 of the NGPA (p. 45a, *infra*). Section 602 allows the states to establish lower ceilings for intrastate gas sales than the federal Act would permit. This Court in Energy Reserves Group, Inc. v. Kansas Power & Light Co., 103 S. Ct. 697 (1983), considered and sustained the constitutionality of the Kansas statute's limiting the operation of indefinite contractual escalation clauses to the NGPA § 109 ceiling. Another Kansas statute enacted in May 1983 and not applicable to the period covered in this case froze all intrastate natural gas prices. 1983 Kan. Sess. Laws ch. 182.

courts under the Supremacy Clause to subordinate state law when it conflicts with federal law.

Natural gas leases and sales contracts are, of course, to a large extent the creatures of state law, to be interpreted according to state law. *Pan American Petroleum Corp.* v. *Superior Court*, 366 U.S. 656, 661-65 (1961); *Skelly Oil Co.* v. *Phillips Petroleum Co.*, 339 U.S. 667 (1950). But they may not be interpreted or enforced in such a way as to conflict with supreme federal law. *See Arkansas Louisiana Gas Co.* v. *Hall*, 453 U.S. 571 (1981). State courts, no less than state legislatures, are bound by the Supremacy Clause. U.S. Const. Art. VI, Cl. 2 ("the Judges in every State shall be bound thereby"); *see Machesky* v. *Bizzell*, 414 F.2d 283 (5th Cir. 1969). Under the Supremacy Clause, a state law or policy that produces " 'a result inconsistent with the object of the federal statute' " or that " 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress' " is void. *Maryland* v. *Louisiana*, 451 U.S. 725, 746-47 (1981), quoting, respectively, *Rice* v. *Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947) and *Hines* v. *Davidowitz*, 312 U.S. 52, 67 (1941).

On a number of occasions, this Court has insisted that state courts subordinate state law principles to federal regulatory policies affecting natural gas. For example, in *Arkansas Louisiana Gas Co.* v. *Hall*, 453 U.S. 571 (1981), the Court reversed a state court's decision to award damages to a producer of natural gas because his purchaser had breached their contract by not paying him what the contract entitled him to. The state court judgment was reversed because the contractual price was higher than the rate the producer had on file with the Federal Power Commission. *Id.* at 581-82. This Court ruled that an award of damages in those circumstances

would violate the "filed rate doctrine," which permits federally regulated entities to collect no more than the rates they have filed with the appropriate federal regulatory agency. *Id.* at 576-78, 582. The Court accordingly rejected the producer's claim that no federal interest had been implicated because the state court had "done no more than determine the damages" he suffered as a result of the breach of contract. *Id.* at 579.

In *California* v. *Southland Royalty Co.*, 436 U.S. 519 (1978), landowners had executed a 50-year lease allowing a producer to produce and market gas and oil from their land. The producer later obtained a permanent certificate of public convenience and necessity under section 7 of the Natural Gas Act to sell gas from the property to an interstate purchaser. Upon the expiration of the lease and its reversion to the lessor, the lessor attempted to sell the gas on the intrastate market without obtaining authority from the Federal Power Commission under section 7(b) of the Natural Gas Act to abandon its service in the interstate market. The Fifth Circuit concluded that abandonment authority was unnecessary because, under state law, the producer-lessee, as a tenant for a term of years, could not have dedicated to the interstate market the portion of the gas that might revert to the lessor.

This Court reversed. It held that, under the Natural Gas Act, the "obligation to continue service attached to the gas, not as a matter of contract but as a matter of law, and bound all those with dominion and power over the gas, including the lessors to whom it reverted." *Id.* at 526. The Court concluded that, while "[p]rivate contractual arrangements might . . . determine *who* is obligated to provide that service, . . . the parties may not simply agree to terminate the service obligation without the Commission's permission." *Id.* at 527 (emphasis in original). The parties were not "free to structure their leasing

arrangements to frustrate the aims and goals of the Natural Gas Act." *Id.* at 530. Thus, the federal regulatory obligation to continue service was held "paramount" to state contract and property rights. *See id.* at 526-27.

In *Northern Natural Gas Co.* v. *State Corporation Comm'n*, 372 U.S. 84 (1963), this Court, reversing a decision of the Kansas Supreme Court, invalidated an attempt by the Kansas State Corporation Commission to require interstate pipelines to purchase ratably from wells connected to their systems. The Court noted that the federal regulatory scheme left "no room either for direct state regulation of the prices of interstate wholesales of natural gas . . . or for state regulation which would indirectly achieve the same result." *Id.* at 91. The Court considered that state-ordered readjustments of purchasing patterns could impair the FPC's power to "regulate the intricate relationship between the purchasers' cost structure and eventual costs to wholesale customers who sell to consumers in other states." *Id.* at 92. Although "collision between the state and federal regulation may not be an inevitable consequence" of the Kansas commission's order, the Court held that the order under review "must be declared a nullity" because of the "*prospect* of interference with the federal regulatory power." *Id.* (emphasis added).

The decision below is inconsistent with those decisions of this Court. To ignore the applicable ceiling on natural gas prices is very plainly to interfere with federal regulation. There is thus in this case more than just a "prospect of interference." Similarly, the "aims and goals" of the Natural Gas Policy Act are frustrated when a state rewards its landowners with royalties based on a rate higher than the rate established by Congress to achieve those aims and goals. The Supremacy Clause stands as a bar to the actions of states interpreting and enforcing private

contracts within their general dominion when such actions interfere or threaten to interfere with or frustrate the aims and goals of federal natural gas legislation. That is no less true when the statute is the Natural Gas Policy Act than when, as in the cases just discussed, the original Natural Gas Act is the governing federal statute.

3. To be sure, the very question presented here has not been decided by this Court. It is a recurring question that should be decided. The Court in *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508, 511 n.2 (1979), noted but did not need in that case to rule on an argument advanced by the FERC that (1) the construction of "market value" royalty clauses of natural gas leases involving regulated gas was a matter of federal law and (2) under federal law the "market" was the regulated market for interstate gas and not what was then the unregulated market for higher-priced intrastate gas. This case obviously poses a variant of the question suggested by the FERC's argument. Another variant of the same recurring question has been or will soon be presented to the Court. At about the time it determined that Kewanee was bound to pay its lessors an amount calculated on the basis of the unattainable stripper-well price, the Kansas Supreme Court also held that "market value" royalties were properly based on a price for interstate gas that exceeded the applicable ceiling price for such gas set by the FPC or the FERC before the enactment of the NGPA. *Matzen* v. *Cities Serv. Oil Co.*, 233 Kan. 846, 667 P.2d 337 (1983), *petition for cert. filed*, No. 83-1234 (Jan. 26, 1984). In that case the question is posed in an aggravated form. As the petitioners there contend, the Kansas court's ruling threatens to exact from them in royalty payments an amount that

leaves then with a very small or insufficient margin to cover other production costs.[7]

Under the principles of *Hall, Southland* and *Northern Natural*, the question whether a state can thus ignore federal natural gas price ceilings can only be answered in the negative. Certainly, as a general rule, where no willing seller can sell to a willing buyer at a price higher than a federally prescribed price, the market value, for federal purposes, can be no higher than the regulated price. Thus, in *United States* v. *Commodities Trading Corp.*, 339 U.S. 121 (1950), this Court held, with respect to computing just compensation under the Fifth Amendment for a commodity subject to price controls, that "ceiling prices of commodities held for sale represented

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[7] Application of the Kansas court's technique in this case to interstate gas or low-priced intrastate gas could result in confiscation. If 1/8 royalties for interstate flowing gas, for which the January 1984 ceiling price under § 104 of the NGPA is 47.8 cents per MMBtu, were calculated on the basis of the § 108 ceiling price, for which the current ceiling is $3.841 per MMBtu, the royalty (48 cents) would exceed the rate that the producer could collect for the sale of the gas. The same situation could occur if the § 105 ceiling, as is possible, limited a producer selling to an intrastate customer to a rate as low as § 104's 47.8 cents, or if the highest and best price paid for "market value" purposes were a deregulated price under § 107 of the NGPA. *See* 18 C.F.R. § 271.101.

While special relief may be available to adjust the federal ceiling price for the producer to accommodate the higher royalty under state law in such circumstances, *see* 18 C.F.R. § 271.402(c)(5), under Supremacy Clause principles, where there is a "prospect of interference" of federal regulation by state law, it is the *state* law that must yield. Northern Natural Gas Co. v. State Corporation Comm'n, 372 U.S. 84, 92 (1963). To avoid such potential conflicts, therefore, as a matter of federal law, for purposes of interpreting royalty clauses "market value" cannot exceed the federal ceiling price.

not only market value but in fact the only value that could be realized by most owners." *Id.* at 124.

That this federal policy would be followed in the case of natural gas has been intimated by the Court of Appeals for the District of Columbia Circuit in *Mobil Oil Corp.* v. *FPC*, 463 F.2d 256, 265 (D.C. Cir.), *cert. denied*, 406 U.S. 976 (1972). The court there held that, as a general matter, royalty holders were not subject to the FPC's jurisdiction under the Natural Gas Act.[8] The court also discussed whether royalty holders could obtain royalties based upon "market" prices in excess of the maximum regulated price. The court suggested that limiting the market value to the ceiling price "would be in furtherance of the general principle against application of contracts so as to contravene public policy, whether or not the result would be in violation of supremacy clause doctrine prohibiting state rules or decisions that require a regulated company to take action inconsistent with Federal regulation." *Id.* at 265. *See Public Service Comm'n* v. *FPC*, 487 F.2d 1043, 1061 (D.C. Cir. 1973) (adverting again to a presumption against computing royalties based upon a "market value" above the regulated ceiling), *vacated on other grounds sub nom. Shell Oil Co.* v. *Public Service Comm'n*, 417 U.S. 964 (1974). This Court cited the relevant pages of the *Mobil* opinion at the point in its *Pennzoil* opinion where it took note of the FERC's argument that the construction of a "market value" royalty clause is a federal question in the resolution of which account must be taken of the limitations on sales price imposed by federal authority. (P. 13, *supra*).

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[8] But see Louisiana Land & Exploration Co. v. FERC, 574 F.2d 204 (5th Cir. 1978) (holding royalty owner subject to Natural Gas Act jurisdiction under the circumstances of that case), *cert. denied*, 439 U.S. 1127 (1979).

4. Kansas stands alone in holding natural gas producers to fictitious market values that, because of federal constraints, their gas does not enjoy. Courts in all other jurisdictions in which the issue has been squarely raised[9] have properly accommodated federal regulatory policies in interpreting "market value" royalty provisions. In *Flowers* v. *Diamond Shamrock Corp.*, 693 F.2d 1146 (5th Cir. 1982), the Court of Appeals for the Fifth Circuit affirmed a district court's holding that the market value for royalty purposes of intrastate gas regulated under section 105 of the NGPA "could not exceed its federally regulated maximum price." *Id.* at 1154. The court recognized that the NGPA "prevented the recovery" of royal-

[9] In Montana Power Co. v. Kravik, 586 P.2d 298 (Mont. 1978), decided before the NGPA took effect, the Montana Supreme Court in dicta appeared to accept the Kansas Supreme Court's earlier pronouncement that federal regulation was not an obstacle to computing royalties based upon a market value higher than the federal ceiling price. *Id.* at 301-02, citing Lightcap v. Mobil Oil Corp., 221 Kan. 448, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977). The Montana court's holding in the case, however, was simply that the price of regulated interstate gas should not be taken into account in determining the market value of unregulated intrastate gas. The "market value" of regulated gas was not an issue in that case.

Prior to the Louisiana Supreme Court's decision in Shell Oil Co. v. Williams, Inc., 428 So.2d 798 (La. 1983), rejecting *Lightcap*, a federal district court in Louisiana also appeared in dicta to agree with *Lightcap's* pronouncement. Agurs v. Amoco Production Co., 480 F. Supp. 737, 738 (W.D. La. 1979). In that opinion denying summary judgment, however, the district court did not decide the degree to which it would take into account federal regulation in determining the market value of the gas there at issue.

In Hoover & Bracken Energies, Inc. v. United States Dep't of Interior, No. 82-1074 (10th Cir. Dec. 28, 1983), the Tenth Circuit cited with apparent approval, but in a different context, the dictum of the *Agurs* opinion. In that case, the Tenth Circuit held that the value

ties attributable to any market value "in excess of the maximum price for intrastate gas permissible" under federal regulation. There, as in this case, the maximum sales price under section 105 was the contract sales price, and accordingly, the court concluded, the market value as well. *Id.*

The Fifth Circuit reached a similar conclusion in *Bowers* v. *Phillips Petroleum Co.*, 692 F.2d 1015 (5th Cir. 1982), with respect to interstate gas under the NGPA, declaring that "federal regulation implicitly affects the amount of royalties based upon the market value of the natural gas produced and sold by the leases." *Id.* at 1017. The highest courts of Louisiana and Texas have also acceded to the effect of federal regulation on "market value" royalty provisions. *Shell Oil Co.* v. *Williams, Inc.*, 428 So.2d 798 (La. 1983); *First Nat'l Bank* v. *Exxon Corp.*, 622 S.W.2d 80 (Tex. 1981); *Exxon Corp.* v. *Middleton*, 613 S.W.2d 240 (Tex. 1981).[10]

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of natural gas produced from leases of federal and Indian lands communitized with private lands included, in addition to the otherwise applicable NGPA ceiling price, a state severance tax paid directly by the gas purchaser. Section 110 of the NGPA, 15 U.S.C. § 3320, permits sellers to collect from purchasers state severance taxes paid by the seller. Thus, a "value" that included severance taxes would not exceed NGPA ceilings if the tax was paid by the seller. The opinion of the Interior Board of Land Appeals that was affirmed by *Hoover & Bracken* noted that the economic substance of the transaction was the same as if the seller had paid the severance tax and passed it along lawfully under the NGPA to the purchaser. Hoover & Bracken Energies, Inc., 52 I.B.L.A. 27, 37-38 (1981). *Hoover & Bracken* accordingly is consistent with the principle that "value" for royalty purposes does not exceed the federal ceiling on the amount a seller may receive directly or indirectly or that a purchaser may pay for the gas.

[10] Other courts have avoided a conflict between state and federal law by holding that the market value of gas for royalty purposes

Nominally, the decisions in these cases (including the Fifth Circuit's decisions applying Texas law) are decisions of state law. But in each it is clear that the state law construction of the "market value" royalty clause was influenced if not determined by the court's perception that a different construction would be vulnerable under the Supremacy Clause. Accordingly, the Kansas court's refusal to accommodate federal law and policy in interpreting and enforcing the royalty clauses in this case directly conflicts with decisions of other state courts of last resort and federal courts of appeals.

CONCLUSION

For the foregoing reasons, the writ of certiorari should issue.

Respectfully submitted,

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January 1984

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cannot exceed its price under a long-term arms-length contract that offered the best price available to the producer at the time, not in excess of federal price ceilings. Hilliard v. Stephens, 276 Ark. 545, 637 S.W.2d 581 (1982); Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981).

APPENDIX

APPENDIX A

IN THE SUPREME COURT OF THE STATE OF KANSAS

No. 54,444

BARBARA HOLMES, Executor of the
Estate of Elmer Holmes, deceased,
Appellee,
v.

KEWANEE OIL COMPANY,
Appellant.

EVELYN WOLKINS,
Appellee,
v.

KEWANEE OIL COMPANY,
Appellant.

SAM BAIER, *et al.*,
Appellee,
v.

KEWANEE OIL COMPANY,
Appellant.

SYLLABUS BY THE COURT

1.

In a case tried to the court it is the appellate court's function to determine if the findings of fact are supported by substantial competent evidence and whether the findings are sufficient to support the trial court's conclusions of law.

2.

A royalty clause which calls for gas royalties to be calculated on the basis of market value refers to value at the current rate prevailing when the gas is delivered rather than the amount realized under a gas purchase contract.

3.

The existence of federal regulation over the rates which a gas producer may receive is no obstacle to the fixing of a higher rate as the "market value" of the gas it sells for the purpose of computing royalties.

4.

Where a division order prepared by the lessee of an oil and gas lease for the lessor's signature unilaterally attempts to amend the oil and gas lease to deprive the royalty owner of interest on royalties held in suspense, to which the royalty owner is otherwise entitled under the leasing contract, and the lessor signs the division order without consideration from the lessee, the mere fact of the lessor's signature does not alter the lease.

5.

Market value of gas is that price which would be paid by a willing buyer to a willing seller in a free market.

6.

Comparable sales of gas are those comparable in time, quality, quantity and availability of marketing outlets.

7.

An oil and gas lease should be construed strictly against the lessee-producer and in favor of the lessor-royalty owner.

8.

The general rule is that an unliquidated claim for damages does not draw interest until liquidated, usually by judgment.

Appeal from Barber district court, CLARENCE E. RENNER, judge. Opinion filed June 10, 1983. Affirmed in part and reversed in part.

Walker A. Hendrix, of Anderson, Byrd & Richeson, of Ottawa, argued the cause and *Michael C. Smith*, of Gulf Oil

Corporation, of Tulsa, Oklahoma, was with him on the briefs for the appellants.

W. Luke Chapin, of Chapin, Penny & Goering, of Medicine Lodge, argued the cause and was on the brief for the appellees.

The opinion of the court was delivered by

HERD, J.: These are consolidated actions on oil and gas leases to recover the difference between royalties paid pursuant to gas purchase contracts and royalties claimed based on market value. The relevant period is 1972 to 1982. The appeal is from the trial court's order awarding the increased royalty payments requested in the amount of $272,391.68, prospective relief and prejudgment interest thereon. The essential facts are undisputed.

The Medicine Lodge gas field was discovered in Barber County in 1927. In 1929, the producer, Barbara Oil Company, executed two gas purchase contracts. The first contract was between Barbara and Harris and Haun, Inc. In 1943 the contract was amended to substitute Zenith Gas Company for Harris and Haun as purchaser. This contract is for the sale of natural gas in interstate commerce and pertains to only one inconsequential lease.

The second contract was entered into between Barbara and the McPherson Oil & Gas Development Company, a drilling company for the Kansas Power & Light Company (KP&L). KP&L later assumed the position of McPherson under the contract. This contract provides for the sale of natural gas intrastate. It covers most of the leases involved in this action.

The market established under the two gas purchase contracts was slow to develop during the depression years of the 1930's. Consequently, many of the oil and gas leases obtained by Barbara did not have production and were allowed to expire during the early years of the gas purchase contracts. The present leases are thus renewal leases and were executed after the two gas purchase contracts had been established. Each

lease contains a gas royalty provision which reads for all purposes pertinent to this appeal as follows:

> "To pay lessor for gas from each well where gas only is found the equal one-eighth (1/8) of the gross proceeds at the prevailing market rate . . . ."

For many years royalties were paid to the lessors on the basis of the prices paid pursuant to the gas purchase contracts. Price increases were agreed upon by the parties through negotiation. In the late 1960's and early 1970's, however, the market value of natural gas began to exceed the purchase price provided for in the contracts. Price increases were prevented by long-term contracts and federal regulations. The lessors, who received royalties on the basis of the proceeds received by the producer, became dissatisfied with the arrangement. To increase the amount of royalties they received the lessors argued they should be paid on the basis of the higher market rate of the gas and not the lower purchase contract price. Toward this end lawsuits were filed in Barber County district court during late 1977 and early 1978 alleging such underpayment of royalties.

After much delay for discovery and negotiations, trial was held before the court in January of 1982. The trial court found for the lessors and awarded them increased royalty payments of $272,391.68, dating from July of 1972 to November of 1981. The court also awarded the lessors prejudgment interest.

The oil producer, Kewanee Oil Company, successor to Barbara Oil Company, appealed. Although not a named party to this action, Gulf Oil Corporation has now acquired the Kewanee Oil Company. Further facts will be developed during a discussion of the issues.

Appellant lists fifteen issues but the basic question is the propriety of the trial court's interpretation of the phrase in the leases "prevailing market rate."

Since this case involves the correctness of the findings of fact and conclusions of law of the trial court, this court's scope of

review on appeal should first be noted. In such a case it is the appellate court's function to determine if the findings of fact are supported by substantial competent evidence and whether the findings are sufficient to support the trial court's conclusions of law. *City of Council Grove* v. *Ossmann*, 219 Kan. 120, 126, 546 P.2d 1399 (1976).

The cause of this controversy can best be understood by a brief look at the history of the problem. It has long been recognized that natural gas, unlike oil, cannot be economically stored in tanks to be sold to the first cutomer who comes along. The sale on delivery of natural gas is accomplished through pipelines. Pipelines are expensive to construct and maintain. In light of these facts gas pipeline companies have historically refused to purchase gas from wells unless the seller signs a long-term contract. To keep pace with rising prices the long-term contracts usually included escalation clauses to afford some relief from the lengthy commitment. In 1954, however, regulation of natural gas sold in interstate commerce was extended to the producer. *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, 98 L.Ed. 1035, 74 S. Ct. 794 (1954). Shortly thereafter the Federal Power Commission, in order to further its policy of keeping gas prices low, suspended operation of escalation clauses in interstate gas contracts. The resulting low prices caused a drop in gas reserve development and interstate commitments. Lack of exploration coupled with rising demand led to rapid price increases in the unregulated intrastate gas market. Substantial price disparities between interstate and intrastate markets and between gas purchase contracts executed at different times thus arose. See Lowe, Developments in Nonregulatory Oil & Gas Law, 32nd Annual Institute on Oil & Gas Law & Taxation 117, 145-46 (1981).

In their attempts to increase the amount of royalties landowners began to rely on "market value" clauses similar to the ones in the leases relevant to this case. Their first major victory came in 1968 when the Texas Supreme Court rendered its decision in *Texas Oil & Gas Corporation* v. *Vela*, 429

S.W.2d 866 (Tex. 1968). The lease in question there provided the lessee was obligated to

> "'pay to lessor, as royalty for gas from each well where gas only is found, while the same is being sold or used off of the premises, one-eighth of the market price at the wells of the amount so sold or used.' " p. 868.

The lessee argued the market price of gas under the lease was the price provided for in the long-term purchase contract between it and the pipeline. In other words, the producer argued market price meant the amount realized under the contract and not the price of gas unencumbered by long-term purchase contracts or federal regulation. The Texas Supreme Court rejected this argument, stating:

> "They [the parties] might have agreed that the royalty on gas produced from a gas well would be a fractional part of the amount realized by the lessee from its sale. Instead of doing so, however, they stipulated in plain terms that the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises. This clearly means the prevailing market price at the time of the sale or use. The gas which was marketed under the long-term contracts in this case was not 'being sold' at the time the contracts were made but at the time of the delivery to the purchaser. [Citation omitted.] We agree with the Court of Civil Appeals, therefore, that the contract price for which the gas was sold by the lessee is not necessarily the market price within the meaning of the lease." 429 S.W.2d at 871.

During the 1970's the disparity between contract prices under old gas contracts and the prevailing market prices increased. In 1977 the Kansas Supreme Court continued the trend set by the Texas court in *Texas Oil & Gas Corp.* v. *Vela. Lightcap* v. *Mobil Oil Corporation*, 221 Kan. 448, 562 P.2d 1, *cert. denied* 434 U.S. 876 (1977), involved several different versions of oil and gas leases. One, however, was for all practical purposes identical to the leases involved in the case at bar. Although there were five separate opinions, a majority of the court clearly agreed that a royalty clause, similar to those here, which calls for gas royalties to be calculated on the basis of market value or market price at the well, refers to value or

price at the current rate prevailing when the gas is delivered rather than the proceeds or amount realized under a gas purchase contract.

The court, however, did not stop there. Aside from holding the market value of gas could be higher than the amount of proceeds under the purchase contract, the court stated market value or price could exceed the amount fixed by federal regulations under the Natural Gas Act of 1938 (15 U.S.C. § 717 *et seq.*), holding:

> "[T]he existence of federal regulation over the rates which a gas producer may receive is no obstacle to the fixing of a higher rate as the 'market value' of the gas it sells for the purpose of computing royalties." 221 Kan. at 457.

Pursuant to *Lightcap*, then, it was proper for the trial court to set a market value for the purpose of determining the amount of royalties owed different from the proceeds realized under the gas purchase contracts. The question is whether the market values set by the trial court were supported by the evidence. To make that determination it is necessary to examine the trial court's decision in more detail.

The decision below followed closely the testimony of R. Douglas Myers, a consulting petroleum engineer and expert witness for the lessors. Myers reached his determination of market value by determining, at yearly intervals from July 1972 through November 1978, the highest and best price paid for natural gas in the Medicine Lodge area. The results were as follows:

Production Period	Fair Market Value ($/mcf)	Control
7-72 thru 1-73	0.1665	KP&L-Medicine Lodge Field
2-73 thru 11-73	0.1850	ONG-Medicine Lodge Field
12-73 thru 4-74	0.5800	KP&L-Patton-Holmes Wells
5-74 thru 4-75	0.8800	KGS-Beren Corp.-Ives Well
5-75 thru 4-76	0.9130	KGS-Beren Corp.-Ives Well
5-76 thru 4-77	2.0350	KGS-Beren Corp.-Ives Well
5-77 thru 4-78	2.0680	KGS-Beren Corp.-Ives Well
5-78 thru 11-78	2.1010	KGS-Beren Corp.-Ives Well

It should be noted from May 1974 through November 1978 Myers and the trial court used the price obtained from the "KGS-Beren Corp.-Ives Well." This refers to a gas purchase contract between Okmar Oil Company and the Kansas Gas Supply Corporation. The leases involved in this contract are located approximately six miles east of the Medicine Lodge gas field.

The Natural Gas Policy Act of 1978 (NGPA) (15 U.S.C. § 3301 *et seq.* [Supp. V 1981]) became effective December 1, 1978. Under the Act intrastate gas, for the first time, became subject to federal price controls. Since, for the time being, both intrastate and interstate gas was subject to regulation, Mr. Myers used a regulated price as his market value beginning December 1, 1978. As he testified at trial Myers believed the highest price being paid for gas in Kansas after enactment of the NGPA was the NGPA section 108 "stripper well" price. 15 U.S.C. § 3318.

Basically, a stripper gas well is one which produces 60,000 cubic feet of gas a day or less. Myers also adjusted for the BTU content of the Medicine Lodge field by taking 1.1 times the section 108 price. The "market value" prices determined by Myers after the passage of the NGPA ranged from $2.45 per mcf in December of 1978 to $3.43 per mcf in October of 1981.

Before proceeding to an analysis of the trial court's order it should be noted no mention was made of any distinction between the interstate gas contract (Zenith) and the intrastate contract (KP&L). There are two reasons for this. First, only one lease in this case involves the Zenith contract. That lease ceased to be economically commercial and was allowed to terminate in May of 1978. It involves increased royalties of only $1200. More important, however, is the principle of *Lightcap* that market value is the issue, irrespective of whether the sale is interstate or intrastate. See 3A Summers, The Law of Oil & Gas § 589 (1983 Supp.)

Appellant first argues the royalty owners signed division orders stipulating their royalty interest was 1/8 of the price

under the gas purchase contracts, thereby altering the lease contracts. A division order is actually part of the gas purchase contract between the producer and the pipeline. It directs the purchaser to make payment for the value of the products taken in certain proportions which are set out in the order itself. Williams & Meyers, Manual of Oil & Gas Terms, pp. 124-25 (3rd ed. 1971). Here the division orders directed the purchaser to pay to the lessors 1/8 of the price paid pursuant to the gas purchase contract. They were signed by the lessors.

This issue was resolved in *Maddox* v. *Gulf Oil Corporation*, 222 Kan. 733, Syl. ¶¶ 2 and 3, 567 P.2d 1326 (1977), *cert denied* 434 U.S. 1065 (1978). The court held:

> "A division order is an instrument required by the purchaser of oil or gas in order that it may have a record showing to whom and in what proportions the purchase price is to be paid. Its execution is procured primarily to protect the purchaser in the matter of payment for the oil and gas, and may be considered a contract between the sellers on the one hand and the purchaser on the other."
>
> "Where a division order prepared by the lessee of an oil and gas lease for the lessor's signature unilaterally attempts to amend the oil and gas lease to deprive the royalty owner of interest on royalties held in suspense, to which the royalty owner is otherwise entitled under the leasing contract, and the lessor signs the division order without consideration from the lessee, the provision waiving interest is null and void."

See also *Wagner* v. *Sunray Mid-Continent Oil Co.*, 182 Kan. 81, 318 P.2d 1039 (1957). We hold the lessor's signatures on the division orders did not alter the leases.

Appellants next argues ratification, estoppel, waiver and acquiesence on the part of the appellees by their having received and kept less than was owed under the terms of the leases. This issue has been resolved in the royalty owners' favor on numerous occasions. In *Foster* v. *Atlantic Refining Company*, 329 F.2d 485, 490 (5th Cir. 1964), the court stated:

> "By keeping less than was due them [the royalty owners], and something to which they were entitled in any event,

the Fosters have not ratified the act of Atlantic in selling their royalty gas for less than the prevailing market price."

In *Texas Oil & Gas Corporation* v. *Vela*, 429 S.W.2d at 876, the Texas Supreme Court held:

> "The operators acquired their interest in the leased premises with actual or constructive knowledge of the provisions of the contracts and the lease. It also is clear that the gas purchase contracts were made in good faith, and as previously indicated the royalty owners have never agreed that royalty should be paid on the basis of the price stipulated therein. In our opinion they are not precluded from insisting upon their rights under the lease by the fact that they or their predecessors in title were parties to and accepted the benefits of the contracts."

We agree and hold the landowners are not barred by ratification, estoppel, waiver or acquiescence.

Let us now turn to a discussion of market value. As previously noted, the trial court made two separate determinations of market value. The first was the pre-December 1978 value. It was based on the highest price paid for comparable natural gas in Barber County at that time. The Okmar contract was the comparable sale used. The second determination pertained to the period after 1978 when intrastate gas became subject to federal regulation. Since there was no unregulated sales at the time that determination was based on the highest regulated price for comparable natural gas in Barber County. The court found the NGPA section 108 price to be the market value of the gas during the second period.

This court has held market value of gas is the "price which would be paid by a willing buyer to a willing seller in a free market." *Lightcap* v. *Mobil Oil Corporation*, 221 Kan. 448, Syl. ¶ 4. Such price may be proven by any competent evidence. Here the trial court relied on evidence of "comparable sales" as the basis of its decision. "Comparable sales of gas are those comparable in time, quality, quantity, and availability of marketing outlets." *Exxon Corp.* v. *Middleton*, 613 S.W.2d 240, 246 (Tex. 1981). See also *Texas Oil & Gas Corp.* v. *Vela*,

429 S.W.2d at 872. In *Lippert* v. *Angle*, 211 Kan. 695, 702, 508 P.2d 920 (1973), we commented on comparable sales, stating: "To be comparable the sales must be similar or under substantially similar conditions." Comparability is a question of fact which will most often be proven by expert testimony. *Weymouth* v. *Colorado Interstate Gas Company*, 367 F.2d 84, 92-93 (5th Cir. 1966); *Exxon Corp.* v. *Middleton*, 613 S.W.2d at 249. Thus, as we noted at the outset, our task is to determine whether the trial court's finding regarding market value and comparable sales are supported by substantial, competent evidence.

The trial court's method in making both determinations of market value was essentially the same. Based on the testimony of Mr. Myers, it simply used the highest price paid for comparable gas in the area both before and after federal regulation of interstate gas. As noted above those prices were obtained from the Okmar contract prior to 1978 and the NGPA section 108 price after 1978. In both instances Myers testified the product for sale was comparable as to physical quality and access to market.

Appellant argues the trial court erred in holding the Okmar contract and the NGPA section 108 sales were comparable. It claims instead that the parties intended at the time the leases were executed that the gas purchase contract price was the market price. Obviously our prior discussion in *Lightcap* is applicable here. In that case we held:

> "Where a lease calls for royalties based on the 'market value' of the gas sold, in the absence of proof of a contrary intent that value is the price which would be paid by a willing buyer to a willing seller in a free market." 221 Kan. 448, Syl. ¶ 4.

Also relevant here is the rule that an oil and gas lease should be construed strictly against the lessee-producer and in favor of the lessor-royalty owner. *Lightcap*, 221 Kan. at 458; *Gilmore* v. *Superior Oil Co.*, 192 Kan. 388, 391, 388 P.2d 602 (1964). This is so because the lease is provided by the lessee who dictates its terms. The lessee thus has the opportunity to

protect itself through specific terminology in the lease. In the absence of any evidence of contrary intent of the parties, we conclude the lessors are entitled to royalties based on the market value of gas at the time of production.

With regard to the trial court's use of the Okmar contract and the NGPA section 108 price as admissible evidence of market value, we have no hesitancy in upholding these actions. Pursuant to K.S.A. 60-407(f) all relevant evidence is admissible except as otherwise provided by statute or constitution. Both standards used by the trial court—the Okmar contract and the NGPA section 108 price—are relevant because of their comparability. As noted above the physical quality and access to market of the gas were similar. Further, there were adequate quantities of each for long-term contracts. Although the use of the NGPA section 108 price may be confusing it is used merely as evidence the gas is worth more than the section 105 price placed on it by the FERC. Just as they are not bound by the gas purchase price, royalty owners with a market value lease are not limited to the regulated price. *Lightcap*, 221 Kan. at 457. This issue is without merit.

Appellant next argues the trial court erred in granting the royalty owners prospective relief based on the section 108 price for the duration of regulation and thereafter the highest price paid for natural gas in Barber County. Appellant maintains that part of the court order unlawfully amends the lease. We agree. The Okmar Contract and the section 108 price are the evidence of market price in this case. They are factual in nature and not controlling on future cases because the market might fluctuate. However, the principals of law enunciated herein are precedential and thereby controlling.

Finally, we must consider the issue of prejudgment interest. The trial court awarded the lessors prejudgment interest on the increased gas royalties at the rate of 6% per annum from the month the original royalty payments were made up to July 1, 1980. After that date and until the date of judgment, February 11, 1982, the rate was 10% per annum. Appellants challenge the propriety of this determination.

It is the "general rule that an 'unliquidated' claim for damages does not draw interest until liquidated - usually by judgment." *Lightcap* v. *Mobil Oil Corporation*, 221 Kan. at 466; *Columbian Fuel Corp.* v. *Panhandle Eastern Pipe Line Co.*, 176 Kan. 433, 271 P.2d 773 (1954). Where a party retains and makes actual use of money belonging to another, however, equitable principles require it to pay interest on the money so retained and used. *Shutts, Executor* v. *Phillips Petroleum Co.*, 222 Kan. 527, Syl. ¶ 20, 567 P.2d 1292 (1977), *cert. denied* 434 U.S. 1068 (1978); *Lightcap*, 221 Kan. 448, Syl. ¶ 12.

Lightcap dealt with a situation which required application of both the general rule and the exception noted above. In applying the general rule to the trial court's decision which had rejected prejudgment interest for increased royalties awarded based on the excess of "market value" over the FPC approved rate, the Supreme Court stated:

> "As to amounts which were determined to be due only when judgment was entered below, we believe the general rule as to unliquidated claims should apply. Apart from the question of liability (one of 'initial impression' as noted by the trial court), the amount due if there was liability was not determined until judgment. The 'market value' of the gas sold was subject to proof at trial by any competent evidence. [Citation omitted.] Here plaintiffs chose to rely on the arbitrated value as establishing market value, and that figure was accepted by the trial court in the absence of any other evidence on the issue. Such a result, however, could not have been foretold before this litigation was well under way, and until that time the total claim was unliquidated." 221 Kan. at 467.

The same is true here. The plaintiffs' claims were unliquidated until the trial court made its determination of market value. We hold the royalty owners were not entitled to prejudgment interest.

The judgment of the trial court is affirmed in part and reversed in part.

APPENDIX B

IN THE DISTRICT COURT OF BARBER COUNTY, KANSAS

No. 77C46

Barbara Holmes, Executor of the
Estate of Elmer Holmes, Deceased,

Plaintiff,

vs.

Kewanee Oil Company,

Defendant.

No. 77C56

Evelyn Wolkins,

Plaintiff,

vs.

Kewanee Oil Company,

Defendant.

No. 78C19

Sam Baier, et al.,

Plaintiffs,

vs.

Kewanee Oil Company,

Defendant.

FILED
BARBER COUNTY, KS
FEB 24 1:47 PM '82
RUTH HAMM
CLERK, DIST. COURT
BY DMMC
Jour. 17, pg. 498

JOURNAL ENTRY

ON the 7th day of January, 1982, the above entitled cases come regularly on for hearing and trial before the court, jury having been waived by the parties.

Plaintiffs appear by and through their attorneys, W. Luke Chapin and Gordon Penny of Chapin, Penny & Goering, Chapin Building, Medicine Lodge, Kansas 67104; and defendants Kewanee Oil Company and Gulf Oil Corporation appear by and through their attorneys, Walker Hendrix of Anderson, Byrd & Richeson, P.O. Box 7, Ottawa, Kansas 66067; and Michael C. Smith, P.O. Box 1589, Tulsa, Oklahoma 74102.

Plaintiffs introduce their evidence and rest. Defendants introduce their evidence and rest. Plaintiffs introduce rebuttal evidence; and the matter is thereupon submitted to the court.

The court announces that it is taking the matter under advisement and requests Suggested Findings of Fact and Conclusions of Law from the parties.

After review of the Suggested Findings of Fact and Conclusions of Law of the parties, having heard the evidence, having read the pleadings, papers and exhibits filed herein, and being well and fully advised in the premises, the court renders its Memorandum Decision which is transmitted to the parties by letter dated February 11, 1982, and said letter and Memorandum Decision are attached hereto and made a part hereof.

IT IS THEREFORE BY THE COURT CONSIDERED, ORDERED, ADJUDGED AND DECREED AS FOLLOWS:

1) The foregoing findings shall be and they are made a part hereof.

2) Plaintiffs shall have and recover judgment against defendants as follows:

In Case Nos. 77C46 and 77C56:

Under B. E. Holmes "D" Lease:

Barbara Holmes to May 1, 1977, $38,435.00

Evelyn Wolkins $27,727.00

J. R. Holmes "A" Lease:

Barbara Holmes $39.00

Evelyn Wolkins -0-

B. E. Holmes Lease:

Barbara Holmes $1,102.00

Evelyn Wolkins $69.00

In Case No. 78C19:

J. C. McKee Lease:

Sam Baier and Bonnie Baier, his wife, $112,823.00

U. L. Thompson "A" Lease:

LaVon Thompson Hoefle, 2/3rds or $37,363.34

U. L. Thompson "B", "C" and "D" Leases:

LaVon Thompson Hoefle, 1/3rd of $144,488.00 or $40,114.50

J. H. Trice "E" Lease:

James H. Trice, Jr., Trustee, 1/2 of 1/8th or $2,290.00

LaVon Thompson Hoefle 1/3rd of 1/8th or $1,525.14.

Trice-Thompson Lease:

James H. Trice, Trustee, 1/4th of 1/8th or $1,224.50

LaVon Thompson Hoefle, 1/3rd of 1/8th or $1,631.03

3) The above amounts represent payments due for increased royalties to November 1, 1981. From and after November 1, 1981, and as long as the price of gas is regulated, the Section 108 "stripper" price, adjusted by 1.1 for btu content, shall be the market value for gas; and plaintiffs are hereby given judgment against defendants for their proportionate amount of the difference between market value of such gas and proceeds paid by KP&L so long as the price of gas is regulated.

4) When and if gas price is deregulated, then the highest and best price paid in the Barber County area for natural gas is

hereby declared to be the market value of natural gas in the Medicine Lodge Gas Field and defendants shall pay plaintiffs their proportionate part of the difference between market value and the proceeds of contract price paid to plaintiffs.

5) Plaintiffs shall have and recover, in addition, interest on increased amounts of gas royalties due at the rate of 6% per annum from the month all original royalty payments were made on all amounts accumulated up until July 1, 1980, and at the rate of 10% per annum thereafter, until date of judgment, which is hereby decreed to be February 11, 1982.

6) After date of judgment, February 11, 1982, interest on increased royalties due and upon the interest so accumulated shall be at the statutory judgment rate of 12% per annum.

7) Defendant Gulf shall pay the costs of the action.

/s/ Clarence E. Renner
CLARENCE E. RENNER
Associate District Judge

APPROVED:

/s/ W. Luke Chapin
W. LUKE CHAPIN of
CHAPIN, PENNY & GOERING
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Ottawa, KS 66067

/s/ By Walker Hendrix
WALKER HENDRIX
Attorneys for Defendant

STATE OF KANSAS
BARBER COUNTY

I do hereby certify the within instrument to be a full, true and correct copy of the recorded instrument as the same appears on record and now on file in the District Court of Barber County, Kansas.

Witness My Hand and Official Seal at Medicine Lodge,

Kansas this 5th day of May 1982
/s/ Doris M. McGinnis
DORIS M. MCGINNIS
Deputy Clerk of the District Court

IN THE DISTRICT COURT OF PRATT COUNTY, KANSAS

Case No. 77C46

Barbara Holmes, Executor o
the Estate of Elmer Holmes, Deceased,

Plaintiff,

-vs-

Kewanee Oil Company,

Defendant.

Case No. 77C56

Evelyn Wolkins,

Plaintiff,

-vs-

Kewanee Oil Company,

Defendant.

Case No. 78C19

Sam Baier, et al.,

Plaintiff,

-vs-

Kewanee Oil Company,

Defendant.

MEMORANDUM DECISION

Pursuant to K.S.A. 60-252, the court makes the following findings of fact and conclusions of law:

1) These cases involve interpretation and application of the gas royalty clauses in the leases under which defendant Gulf and its predecessor companies have been operating, as follows:

"Second. To pay lessor for gas from each well where gas only is found the equal one-eighth (1/8th) of the gross proceeds at the prevailing market rate, for all gas used off the premises, said payments to be made monthly . . ."

2) Gas was discovered in the Medicine Lodge Field in 1927, pipelines were connected to the wells in about 1929, the oil and gas leases in question in this case were executed in the 1930's, and the leased premises have produced gas for many years.

3) Plaintiffs' share of the 1/8th royalty has been paid based on contract prices under contracts by leases to Kansas Power & Light Company (KP&L), and Zenith Gas Company (Zenith). The KP&L contract is an intrastate contract, made in 1929, and involves gas sold in Kansas. The Zenith contract, also made in 1929, is an interstate contract and involves gas sold in interstate commerce. Both the Zenith contract and the KP&L contract were made by defendant's predecessor in title as seller several years before the leases in question here were executed and several years before any wells had been drilled on plaintiffs' property.

4) The leases involved in this case appear as follows:

a. Lease dated June 10, 1936 between John Charles McKee and Christine McKee, his wife, lessors, and C. B. Shaffer, lessee, covering the NW/4 of the NW/4 and the NE/4 of the NE/4 in Section 21, Township 33S, Range 13W.

b. Lease dated December 4, 1936, between U. L. Thompson and Elma Thompson, his wife, lessors, and Barbara Oil Company, lessee, covering the E/2 of Section 16, Township 33S, Range 13W.

c. Lease dated December 4, 1936, between U. L. Thompson and Elma Thompson, his wife, lessors, and Barbara Oil Company, lessee, covering the W/2 of Section 16, Township 33S, Range 13W.

d. Lease dated October 22, 1935 between J. H. McKee and Alice McKee, his wife; Flora J. Crouch and A. T. Crouch, her husband; Emma Bell Johnson and Henry

Johnson, her husband; William J. McKee and Minnie McKee, his wife; Eliza J. Carpenter and Lloyd Carpenter, her husband; and John Charles McKee and Christine McKee, his wife, heirs at law of Ellen E. McKee, deceased, lessors, and C. B. Shaffer, lessee, covering the E/2 of Section 20; the S/2 of the N/2, the NW/4 of the NE/4, NE/4 of the NW/4 and the S/2 of Section 21; and the W/2 of the NE/4 and E/2 of the NW/4 of Section 28, Township 33S, Range 13W.

e. Lease dated November 8, 1934 between U. L. Thompson and Elma Thompson, husband and wife, lessors, and Barbara Oil Company, lessee, covering W/2 of Section 22, Township 33S, Range 13W.

f. Lease dated July 27, 1929 between U. L. Thompson and Elma Thompson, his wife, lessors, and Barbara Oil Company, lessee, covering the S/2 of the S/2 of Section 9, Township 33S, Range 13W.

g. Lease dated March 21, 1938 between J. H. Trice and Edna S. Trice, his wife, lessors and D. S. Shaw, lessee, covering the SE/4 of the SW/4 of Section 4; the N/2 of the NE/4 of Section 8; and the N/2 and the N/2 of the S/2 of Section 9, Township 33S, Range 13W.

h. Lease dated December 16, 1976 between Elmer E. Holmes and Barbara Holmes, his wife, lessors, and Kewanee Oil Company, lessee, covering the SE/4 of Section 28, Township 33S, Range 13W.

i. Lease dated July 16, 1927 between J. R. Holmes and Lois E. Holmes, his wife, lessors, and Barbara Oil Company, lessee, covering SE/4 of Section 28, Township 33S, Range 13W.

j. Lease dated April 5, 1937 between B. E. Holmes, a single man, lessor and Barbara Oil Company, lessee, covering the E/2 of the NE/4 of Section 28, and the W/2 of the NW/4 of Section 27, Township 33S, Range 13W.

k. Lease dated December 3, 1936 between B. E. Holmes, a single man, lessor and Barbara Oil Company, lessee, covering SE/4 of Section 15, Township 33S, Range 13W.

5) It was stipulated by the parties that plaintiffs under the Holmes leases, Cases Nos. 77C46 and 77C56 are entitled to

all of the 18th royalty interest in the gas. Barbara Holmes was entitled to such 1/8th interest up until date of death of her husband, Elmer, on May 16, 1977; and thereafter the daughter of Barbara and Elmer, Evelyn Wolkins, is entitled to all of the 1/8th gas royalty interest.

6) It was stipulated that Sam Baier is the purchaser of the McKee land and is entitled to all of the 1/8th gas royalty interest under the McKee leases.

7) It was stipulated that under the U. L. Thompson "A" lease, plaintiff LaVon Thompson Hoefle is entitled to 2/3rds of the 1/8th gas royalty interest; and she is entitled to 1/3rd of the 1/8th gas royalty interest under the U. L. Thompson "B", "C" and "D" leases.

8) It was also stipulated that under the J. H. Trice lease, James H. Trice, Jr., trustee, is entitled to 1/2 of the 1/8th gas royalty and LaVon Thompson Hoefle is entitled to 1/3rd of the 1/8th gas royalty; and under the Trice-Thompson lease, James H. Trice, Jr., trustee, is entitled to 1/4th of the 1/8th gas royalty and LaVon Thompson Hoefle is entitled to 1/3rd thereof.

9) By stipulation of the parties the gas royalty clause in the Parker lease, Page 461 of *Lightcap* v. *Mobil Oil Corporation*, 221 Kan. 448, 562 P.2d 1, is almost exactly like the gas royalty clauses in the leases in question; and that under the holding in *Lightcap*, the leases here involved are "market value" leases; and the court so finds.

10) The court further finds, according to Syllabus No. 3 of *Lightcap*, that the existence of federal regulation fixing the maximum rate a gas producer may receive from its purchaser is no obstacle to the fixing of a higher rate as the "market value" of the gas it sells for the purpose of computing royalties.

11) The principal issue in this case is, "What was and is the 'market value' of the gas for the five years preceding the filing of petitions in these cases (time as limited by statutes of limitation) and at the present time, as compared to royalties received by plaintiff lessors under gas purchase contracts entered into by the lessees?"

12) The court finds that the five year statute of limitations applies to plaintiffs' claim from date of filing of petition.

13) KP&L and Zenith gas purchase contracts and amendments thereto, have been entered herein as exhibits. These gas purchase contracts and amendments are between the lessee, the gas producers, and the gas purchasers. Lessors, plaintiffs in these cases, have had no part in the making of such contracts or amendments.

14) Also entered as exhibits are the many gas transfer orders and gas division orders obtained by KP&L and Zenith since 1929 when the gas purchases began. The KP&L division orders and transfer orders all read substantially the same as follows:

> "2. The natural gas purchased and received under this division order shall be paid for to the respective owners or their assigns in proportion to their respective interests as above shown, at the price and under the provisions specified in a certain written contract between Barbara Oil Company and the Kansas Power & Light Company dated June 1, 1929, as amended, which contract is made a part of this instrument by reference."

The Zenith division orders read substantially the same as follows:

> "1. This division order is executed subject to a contract made and entered into by and between Barbara Oil Company, as seller, and Oklahoma Natural Gas Company, as buyer, dated May 14, 1929 . . ."

> "3. The purchase price for said gas shall be the price designated in said contract, and payment thereof (less applicable taxes to be deducted by you) shall be made to the parties above named in the proportions above set forth, at the respective times and under the conditions contained in said contract."

15) R. Douglas Myers, a consulting petroleum engineer, of Wichita, Kansas, and a man of many years experience in production of natural gas in the State of Kansas and operation and appraisal of natural gas properties, particularly in Barber

County, Kansas, testified for the plaintiffs. His opinion was that the uncontrolled price of natural gas would be as high as \$4.00 to \$4.50 per mcf; and he pointed out that natural gas was bringing as much as \$9.50 per thousand cubic feet produced from the deep gas fields of the Anadarko Basin of Oklahoma. However, for purposes of making a study of the market value of natural gas in the Medicine Lodge Field, he used the highest and best prices paid for natural gas in the Barber County area during the periods from July, 1972, through November 1978. Thereafter, he did not attempt to determine the unregulated price of gas, but, because all natural gas, intrastate and interstate, was controlled by the Natural Gas Policy Act of 1978, beginning December 1, 1978, he used the Section 108 price, the so-called "stripper" price from that period on. The stripper price has been adjusted upward monthly according to certain inflation indexes. In addition, he multiplied the ordinary maximum stripper price by 1.1 to adjust for 1,100 btu content of gas from the Medicine Lodge Field. It is his opinion that market value or market rate is not the average rate paid during a certain period, but is the highest and best rate paid in the area. It is further his opinion that the gas from the leases in question is comparable in physical quality and availability of pipeline market to gas being sold for the highest and best prices in Barber County, Kansas.

16) Doug Myers determined that the highest and best prices paid or contracted for during the periods in question in the Barber County area up until the NGPA price were as follows:

Production Period	Fair Market Value (\$/mcf)	Control
7-72 through 1-73	0.1665	KP&L-Medicine Lodge Field
2-73 through 11-73	0.1850	ONG-Medicine Lodge Field
12-73 through 4-74	0.5800	KP&L-Patton-Holmes Wells
5-74 through 4-75	0.8800	KGS-Beren Corp.-Ives Wells
5-75 through 4-76	0.9130	KGS-Beren Corp.-Ives Wells
5-76 through 4-77	2.0350	KGS-Beren Corp.-Ives Wells
5-77 through 4-78	2.0680	KGS-Beren Corp.-Ives Wells
5-78 through 11-78	2.1010	KGS-Beren Corp.-Ives Wells

17) Increases, according to Doug Myers' reports, from five years before filing of petitions through October, 1981, without interest, are as follows:

Lease Name	Total Royalty Increase	Plaintiffs' Share	Net for Plaintiffs
B. E. Holmes "D"	$ 66,162.00	All	$ 66,162.00
J. R. Holmes "A"	39.00	All	39.00
B. E. Holmes	1,171.00	All	1,171.00
J. C. McKee (Baier)	112,823.00	All	112,823.00
U. L. Thompson "A"	56,017.00	2/3	37,344.00
U. L. Thompson "B"	69,734.00	1/3	23,244.00
U. L. Thompson "C"	53,813.00	1/3	17,937.00
U. L. Thompson "D"	20,941.00	1/3	6,980.00
J. H. Trice	4,580.00	1/2 Trice	$2,290.00
	4,580.00	1/3 LaVon	1,526.00
Trice-Thompson	4,898.00	1/4 Trice	1,224.00
		1/3 LaVon	1,632.00
Total due from Gulf without interest			$272,372.00

17) Defendant Gulf's market value expert was Frank Bolton, Jr. He is an attorney and former Vice President of Mobil Oil Corporation. He is an expert in Federal Power Commission matters and in marketing of gas. He made a report shown at Defendant's Exhibit 16 of transaction prices used in Barber County intrastate gas market study from 1974 through 1978 and shown in Defendant's Exhibit 17 as intrastate market value of Kansas gas during the period January 1, 1974, through November 1978, by month. Using his figures, Nancy Parker, an accountant with Gulf Oil Corporation, came up with total increase in royalty settlements due plaintiffs of $68,138.00. Her accounting for increases is summarized as follows:

Lease Name	Royalty Settlement	Plaintiffs' Share
B. E. Holmes "D" Lease	$20,049.00	$20,049.00
J. R. Holmes "A" Lease	23.00	23.00
B. E. Holmes Lease	690.00	690.00
J. C. McKee Lease	23,145.00	23,145.00

U. L. Thompson "A" Lease	23,311.00	15,548.00
U. L. Thompson "B" Lease	6,477.00	2,159.00
U. L. Thompson "C" Lease	4,312.00	1,437.00
U. L. Thompson "D" Lease	10,858.00	3,619.00
J. H. Trice "E" Lease	959.00	800.00
Trice-Thompson Lease	1,145.00	668.00
Total Royalty Settlement	$90,969.00	
Plaintiffs' Total Share		$68,138.00

Mr. Bolton admitted that he took his data partly from FERC reports of new contracts for purchase of natural gas in the State of Kansas, without considering renegotiated or amended contract prices for gas, and also from a tabulation received from Kansas Gas Supply Company, a company purchasing gas for intrastate distribution in the State of Kansas, reporting new contracts made by Kansas Gas Supply by month, in the State of Kansas, and prices paid. He admitted that he had no knowledge of where in the State of Kansas the gas production might be located, whether northeast, northwest, central, southwest or southeast. He further admitted that he had no knowledge of whether there were no pipelines, one pipeline or two or more pipelines in the gas producing areas where the contracts were made; that if there were several pipelines the market for gas would be higher; that he had not examined any of the contracts relating to purchase prices stated in his survey. He further admitted that if gas wells are scattered over a large area, the gas is worth less than if the wells are in a compact geographical area; that if the wells can deliver only a few thousand mcf per day, the gas ordinarily is worth less than if they can produce one or two million mcf per day; that if gas is of such low pressure as to require compression, then it ordinarily is worth less than if it can flow into the pipeline at its own pressure; and, in general, that he had no knowledge concerning the gas purchase contracts or gas production reported in his study except for the amount of the new contract made and reported in certain of the months in the five years involved.

18) Mr. Bolton further attempted to explain his ignoring renegotiated or redetermined contracts on the ground that the

renegotiation or redetermination was based on prices someone else had paid for natural gas in the area. He said that the Kansas Gas Supply-Beren-Ives Well price was ignored for that reason. However, he did not explain why an amendment to that contract required Kansas Gas Supply to build its own compressor and pick up natural gas at low gas pressure, at the higher price reported by Doug Myers, from some wells in Barber County, Kansas, west of Hardtner, Kansas.

19) Mr. Bolton further attempted to explain that after December 1, 1978, the gas was Section 105 NGPA gas, limited to the "contract price" and that comparable sales of natural gas must consist of gas of the same "legal quality". On cross-examination, he admitted that the term "legal quality" meant nothing more than whether the gas was sold intrastate or interstate and what federal or state controls of the price of natural gas applied.

20) The further opinion of Doug Myers was that as long as gas is controlled by the Natural Gas Policy Act, the stripper gas price, multiplied by 1.1 should be determined to be the price for which plaintiffs should be paid their gas royalty. It is his further opinion that when and if the price of natural gas is deregulated, the highest and best price paid in the Barber County area, adjusted annually, would be the market price to be paid plaintiffs for their gas royalties.

21) In May, 1974, Okmar Oil Company contracted with Kansas Gas Supply Corporation to sell gas from certain leases consisting of about 2,560 acres located about six miles east of the Medicine Lodge Gas Field leases here in question. (See Plaintiffs' Exhibits 2 and 3, Okmar Contracts.) Sales were to commence as soon as Kansas Gas Supply, exercising due diligence, could build a line to the wells. Beginning price to be paid was 88 cents per mcf as compared to the 16.65 cents Gulf's predecessor was then selling for under the old KP&L contract. Gulf alleges that this sale was not of comparable gas, but the evidence shows:

a. The gas was of comparable btu content.

b. Pressures were higher in the new Okmar wells. However, reserves and deliverability were well-established and well-known in the old Medicine Lodge Field and were comparable to the Okmar wells.

c. There were four or five pipelines in the area of the Medicine Lodge Gas Field, while in the Okmar field there was none and a pipeline had to be built. This would have made Okmar gas less valuable.

d. Both the Okmar wells and the wells here in question were in a compact geographical location.

e. Sales from the Okmar area were much more comparable than any of the sales reported by Gulf's expert from unknown wells in unknown locations over the entire State of Kansas.

The defendant strenously contends that the wells in question in this case are "old wells" substantially depleted, and therefore cannot be considered with the same degree of value as new wells. It can only be noted, that in light of all the testimony, that if these wells were discovered today, drilled and began producing with present remaining reserves, they would still be regarded as very good wells. In view of this the court finds that the Okmar sale was comparable to what the Medicine Lodge Field gas would have sold for on an open, unregulated intrastate market during the same time period.

22) Most of the wells on the leases in question have produced gas for over 35 years. Even during the period 1972 to 1978, they produced at the rate of over 1.2 million cubic feet per day. Defendant Gulf and its predecessors have received 7/8ths of the proceeds of sale, while plaintiff royalty owners and their predecessors, original owners of the gas, have received only 1/8th.

It was not until the late 1960's or early 1970's that market value of gas began to exceed contract rates. Gulf alleges that at market value rate as established by Doug Myers, there is a short period in the 1972 to 1978 time frame when Gulf's predecessor, Kewanee Oil, would have received only about 1/3rd of proceeds of sale of the gas, while gas royalty owners would

have received about 2/3rds. But by that time, cost of drilling and completing the gas wells had been paid for many many times over; and a more accurate average division of payments under "market value" that same five years would be about 3/4ths to the lessee-gas producer and 1/4th to the lessor-royalty owners. (See Plaintiffs' Exhibit 1, Doug Myers' Report.) Plaintiff royalty owners should have and receive the benefit of their original market value leases.

CONCLUSIONS OF LAW

1) The terms "market price", "market value", and "market rate", are synonymous and can be used interchangeably. All of such terms are construed to mean what would be paid by a willing buyer to a willing seller in a free market (*Lightcap*, Syllabus 4); and such price is not controlled by federal regulation. (*Lightcap*, Syllabus 3 and 13.)

2) Up until December 1, 1978, the price of gas being sold in intrastate commerce was not subject to federal or state regulation and the highest and best prices paid in the Barber County area as reported by R. Douglas Myers are determined to be the market prices for the gas for those particular periods in accordance with Finding No. 14 above.

3) Gulf alleges defenses of estoppel, laches, ratification and accord and satisfaction by reason of royalty owners accepting 1/8th of "proceeds of sale" checks for many years, but by keeping less than was due them in gas royalties, and something to which they were entitled in any event, the plaintiffs have not ratified the act of Gulf in selling the gas for less than what was the prevailing market price. (*Foster, et al.* v. *Atlantic Richfield Company*, U.S. Court of Appeals, 5th Cir., 329 F2d 485 (1964); *Texas Oil & Gas Corp.* v. *Bela*, Texas Supreme Court, 429 S.W.2d 866 (1968); *Gray* v. *Amoco Production Company*, 1 Kan. App. 2d 338, Page 346.)

4) "A division order is an instrument required by the purchaser of oil or gas in order that it may have a record showing to whom and in what proportions the purchase price is

to be paid. Its execution is procured primarily to protect the purchaser in the matter of payment for the oil or gas, and may be considered a contract between the sellers on the one hand and the purchaser on the other. (Citing cases.) Generally speaking, a division order is not a contract between sellers themselves, especially in view of the fact that each of the parties having an interest in production may in fact execute separate division orders." (Citing cases.) (*Wagner* v. *Sunray Midcontinent Oil Co.*, 182 Kan. 81, 318 P2d 1029, at Page 92.)

5) As stated in Maddox v. Gulf Oil Corporation, 222 Kan. 733, 567 P.2d 1326:

> "The insertion in the division orders of matters contrary to oil and gas leases, or contrary to the law, cannot be unilaterally imposed upon the lessor by the lessee or the purchaser."

Here, the provision in the division orders to divide the purchase price under the contract in the proportions stated cannot be construed to amend the oil and gas leases.

6) The unregulated market value or market rate for natural gas, on the free or open market, if there were one, would be higher than any regulated price. However, plaintiffs have agreed to accept the Section 108 price or stripper price, adjusted for btu content, in Barber County, Kansas, since December 1, 1978, up to date, and in the future, so long as gas price is regulated. Therefore, the court finds and concludes that the report of R. Douglas Myers will be accepted as market value and the difference between market value and price paid, up to date, and judgment hereby is rendered for the plaintiffs accordingly.

7) Also, according to Mr. Myers' testimony, so long as the price of gas is regulated, the Section 108 "stripper" price, adjusted by 1.1 for btu content, is hereby adjudged to be the market value for gas from December 1, 1978, and as long as gas price is regulated; and judgment is rendered accordingly.

8) When and if gas price is deregulated, then the highest and best price paid in the Barber County area for natural gas is

hereby declared to be the market value of natural gas in the Medicine Lodge Field and defendant shall pay for the gas accordingly, regardless of the contract price with KP&L or with Zenith.

9) Plaintiffs are hereby given judgement for interest on increased amounts of gas royalties due at the rate of 6% per annum from the month all original royalty payments were made on all amounts accumulated up until July 1, 1980, and at the rate of 10% per annum thereafter, until date of judgement. After date of judgement, interest on increased royalties due and upon the interest so accumulated shall be at the statutory judgement rate of 12% per annum. (K.S.A. Supp. 16-201: *Lippert* v. *Angle*, 215 Kan. 626, 627, 527 P.2d 1016; *Lightcap* v. *Mobil Oil Corporation*, 221 Kan. 448, 562 P.2d 1; and *Shutts* v. *Phillips Petroleum Company*, 222 Kan. 527, Syllabus 21.)

10) The foregoing findings are made a part hereof. Defendant Gulf shall pay costs of the action.

11) Attorneys for plaintiffs are requested to draw the Journal Entry, accordingly.

/s/ Clarence E. Renner
CLARENCE E. RENNER
Judge, District Court

Original- File
Carbon Copy: Mr. Luke Chapin
CHAPIN, PENNY & GOERING
Attorney for Plaintiffs
Chapin Building
Medicine Lodge, Kansas 67104

Mr. Walker Hendrix
ANDERSON, BYRD & RICHESON
Attorney for Defendants
P.O. Box 7
Ottawa, Kansas 66067

Mr. Michael C. Smith
Attorney for Defendants
P.O. Box 1589
Tulsa, Oklahoma 74102

APPENDIX C

IN THE DISTRICT COURT OF BARBER COUNTY, KANSAS

No. 77C46

BARBARA HOLMES, Executor of the Estate of Elmer Holmes, Deceased,

Plaintiff,

vs.

KEWANEE OIL COMPANY,

Defendant.

No. 77C56

EVELYN WOLKINS,

Plaintiff,

vs.

KEWANEE OIL COMPANY,

Defendant.

No. 78C18

GORDON PENNY, *et al.*,

Plaintiff,

vs.

GETTY OIL COMPANY,

Defendant.

No. 78C19

SAM BAIER, *et al.*,

Plaintiff,

vs.

KEWANEE OIL COMPANY,

Defendant.

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Journal 16, pg. 593

JOURNAL ENTRY

NOW, on this 11th day of March, 1981, these cases come on for hearing on the motions of defendants to refer issues under Natural Gas Policy Act of 1978 to the Federal Energy Regulatory Commission. Plaintiffs are present by and through W. Luke Chapin, of Chapin, Penny & Goering, their attorneys; defendant Kewanee Oil Company is present by and through Walker A. Hendrix, Anderson Byrd & Richeson, its attorney; and defendant Getty Oil Company is present by and through Timothy E. McKee of Martin, Pringle, Fair, Davis & Oliver, its attorney.

THEREUPON the matter is argued to the court by counsel and the court, having read the briefs and heard the argument of counsel and being well and fully advised in the premises finds and orders that said motions should be and they are hereby overruled.

THEREUPON, counsel for Kewanee Oil Company orally moves the court for an order permitting it to take an interlocutory appeal, which motion is by the court denied.

IT IS BY THE COURT SO ORDERED.

/s/ Clarence E. Renner
CLARENCE E. RENNER
Associate District Judge

APPROVED:

/s/ Walker A. Hendrix
WALKER A. HENDRIX
Attorney for Kewanee Oil Company

/s/ Timothy E. McKee
TIMOTHY E. MCKEE
Attorney for Getty Oil Company

/s/ W. Luke Chapin
W. LUKE CHAPIN
Attorney for Plaintiffs

APPENDIX D

IN THE DISTRICT COURT OF BARBER COUNTY, KANSAS

No. 78C10

SAM BAIER, et al.,

Plaintiffs,

v.

KEWANEE OIL COMPANY,

Defendant.

No. 77C56

EVELYN WOLKINS,

Plaintiff,

v.

KEWANEE OIL COMPANY,

Defendant.

No. 77C46

BARBARA HOLMES, Executor of
The Estate of Elmer Holmes,
Deceased,

Plaintiff,

v.

KEWANEE OIL COMPANY,

Defendant.

JOURNAL ENTRY ON MOTIONS

ON this 28th day of September, 1981, hearing is had at Pratt, Kansas, by agreement of parties, on various motions before

the court. Plaintiffs are present by and through Gordon Penny and W. Luke Chapin of Chapin, Penny & Goering, Medicine Lodge, Kansas, their attorneys; and defendant is present by and through Walker Hendrix, Ottawa, Kansas, its attorney.

THEREUPON, the following motions were argued to the court:

1. Plaintiffs' Motion for Partial Summary Judgment.

2. Defendant's Motion for Protective Order.

3. Plaintiffs' Motion to Compel Answers to Interrogatories.

The court, after hearing the arguments of counsel, finds and orders as follows:

1) Plaintiffs' Motion for Partial Summary Judgment is denied at this time.

2) Defendant's Motion for Protective Order and Plaintiffs' Motion to Compel Answers to Interrogatories are denied at this time.

THEREUPON, the court sets the date of December 9, 1981, at 1:30 p.m., at Medicine Lodge, for pre-trial of the above cases. The court further sets January 8 and 9, 1982, at Medicine Lodge, Kansas, for trial of the actions.

Counsel for defendant further agrees to inform counsel for plaintiff within two weeks who his witnesses will be and the substance of their testimony.

IT IS BY THE COURT SO ORDERED.

/s/ Clarence E. Renner
Associate District Judge
CLARENCE E. RENNER

APPROVED:

/s/ W. Luke Chapin
W. LUKE CHAPIN

/s/ Walker Hendrix
WALKER HENDRIX

APPENDIX E

IN THE DISTRICT COURT OF BARBER COUNTY, KANSAS

No. 77C46

BARBARA HOLMES, Executor of
The Estate of Elmer Holmes,
Deceased,

Plaintiff,

v.

KEWANEE OIL COMPANY,

Defendant.

No. 77C56

EVELYN WOLKINS,

Plaintiff,

v.

KEWANEE OIL COMPANY,

Defendant.

No. 78C19

SAM BAIER, et al.,

Plaintiffs,

v.

KEWANEE OIL COMPANY,

Defendant.

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ORDER ON DEFENDANT'S MOTION

ON the 22nd day of March, 1982, the above entitled cases come on for hearing on defendant's motion, plaintiffs appearing by and through their attorney, W. Luke Chapin, of Chapin, Penny & Georing, Medicine Lodge, Kansas 67104; and defendants Kewanee Oil Company and Gulf Oil Corporation appearing by and through their attorney, Walker Hendrix, of Anderson, Byrd & Richeson, P. O. Box 7, Ottawa, Kansas 66067.

THEREUPON, defendant's motion is argued to the court by counsel; and the court having examined the files and heard the arguments of counsel and being well and fully advised in the premises finds that the motion should be overruled.

IT IS THEREFORE BY THE COURT ORDERED that defendant's motion to set aside findings of fact and conclusions of law, to make new and additional findings of fact and conclusions of law, and to alter amend the judgment entered herein, be and it is hereby overruled.

/s/ Clarence E. Renner
Associate District Judge
CLARENCE E. RENNER

APPROVED:

/s/ W. Luke Chapin
W. LUKE CHAPIN of
CHAPIN, PENNY & GOERING
Medicine Lodge, KS 67104
Attorneys for Plaintiffs

/s/ Walker Hendrix
WALKER HENDRIX of
ANDERSON, BYRD & RICHESON
P. O. Box 7
Ottawa, KS 66067
Attorneys for Defendant

APPENDIX F

IN THE SUPREME COURT OF THE STATE OF KANSAS

No. 82-54444-AS

BARBARA HOLMES, Executor of
The Estate of Elmer Holmes,
Deceased,

Appellee

v.

KEWANEE OIL COMPANY,

Appellant

EVELYN WOLKINS,

Appellee

v.

KEWANEE OIL COMPANY,

Appellant

SAM BAIER, et al.,

Appellees

v.

KEWANEE OIL COMPANY,

Appellant

You are hereby notified of the following action taken in the above entitled case:

Motion for rehearing.

Considered by the Court and denied.

Date Sept. 30, 1983

Yours very truly,

LEWIS C. CARTER
Clerk, Supreme Court

APPENDIX G

Excerpts from the Natural Gas Policy Act of 1978, 92 Stat. 3358, 15 U.S.C. § 3301 *et seq.*

§ 102, 15 U.S.C. § 3312 (in part). CEILING PRICE FOR NEW NATURAL GAS AND CERTAIN NATURAL GAS PRODUCED FROM THE OUTER CONTINENTAL SHELF

(a) APPLICATION. The maximum lawful price computed under subsection (b) shall apply to any first sale of natural gas delivered during any month in the case of—

(1) new natural gas; and

(2) natural gas produced from any old lease on the Outer Continental Shelf and qualifying under subsection (d) for the new natural gas ceiling price.

(b) MAXIMUM LAWFUL PRICE. The maximum lawful price under this section for any month shall be—

(1) $1.75 per million Btu's, in the case of April 1977; and

(2) in the case of any month thereafter, the maximum lawful price, per million Btu's prescribed under this subsection for the preceding month multiplied by the monthly equivalent of a factor equal to the sum of—

(A) the annual inflation adjustment factor applicable for such month; plus

(B)(i) .035, in the case of any month beginning before April 20, 1981;

or

(i) .04, in the case of any month beginning after April 20, 1981.

. . .

§ 105, 15 U.S.C. § 3315 (in part). CEILING PRICE FOR SALES UNDER EXISTING INTRASTATE CONTRACTS

(a) APPLICATION. The maximum lawful price computed under subsection (b) shall app[illegible] to any first sale of natural gas delivered during any month in the case of natural gas, sold under

any existing contract or any successor to an existing contract, which was not committed or dedicated to interstate commerce on the day before the date of the enactment of this Act.

(b) MAXIMUM LAWFUL PRICE. (1) General rule. Subject to paragraphs (2) and (3), the maximum lawful price under this section shall be the lower of—

(A) the price under the terms of the existing contract, to which such natural gas was subject on the date of the enactment of this Act, as such contract was in effect on such date; or

(B) the maximum lawful price, per million Btu's, computed for such month under section 102 (relating to new natural gas).

(2) Contract price exceeding new gas ceiling price on enactment. In the case of any natural gas described in subsection (a) for which the contract price applicable on the date of the enactment of this Act exceeds the maximum lawful price, per million Btu's, computed for such date under section 102 (relating to new natural gas), the maximum lawful price under this section shall be the higher of—

(A) the maximum lawful price, per million Btu's, computed for such month under section 102; or

(B)(i) the contact [contract] price on the date of the enactment of this Act, in the case of the month in which this Act is enacted; and

(ii) in the case of any month thereafter, the maximum lawful price, per million Btu's, prescribed under his subparagraph for the preceding month multiplied by the monthly equivalent of the annual inflation adjustment factor applicable for such month.

. . .

(c) DEFINITION OF CONTRACT PRICE. For purposes of this section. the term "contract price", when used with respect to any specific date, means—

(1) The price paid, per million Btu's, under a contract for deliveries of natural gas occurring on such date; or

(2) if no deliveries of natural gas occurred under such contract on such date, the price, per million Btu's, that would have been paid had such deliveries occurred on such date.

§ 108, 15 U.S.C. § 3318. CEILING PRICE FOR STRIPPER WELL NATURAL GAS

(a) GENERAL RULE. In the case of any first sale of stripper well natural gas the maximum lawful price under this section for such natural gas delivered during any month shall be—

(1) $2.09 per million Btu's, in the case of May 1978; and

(2) in the case of any month thereafter, the maximum lawful price, per million Btu's, prescribed under this subsection for the preceding month multiplied by the monthly equivalent of a factor equal to the sum of—

(A) The annual inflation adjustment factor applicable for such month; plus

(B)(i) .035, in the case of any month beginning before April 20, 1981;

or

(ii) .04, in the case of any month beginning after April 20, 1981.

(b) DEFINITION OF STRIPPER WELL NATURAL GAS. (1) General rule. Except as provided in paragraph (2), the term "stripper well natural gas" means natural gas determined in accordance with section 503 to be nonassociated natural gas produced during any month from a well if—

(A) during the preceding 90-day production period, such well produced nonassociated natural gas at a rate which did not exceed an average of 60 Mcf per production day during such period; and

(B) during such period such well produced at its maximum efficient rate of flow, determined in accordance with recognized conservation practices designed to maximize the ultimate recovery of natural gas.

(2) Production in excess of 60 Mcf. The commission shall, by rule, provide that, if nonassociated natural gas produced from a well which previously qualified as a stripper well under paragraph (1) exceeds an average of 60 Mcf per production day during any 90-day production period, such natural gas may continue to qualify as stipper well natural gas if the increase in nonassociated natural gas produced from such well was the result of the application of recognized enhanced recovery techniques.

(3) Definitions. For the purposes of this subsection—

(A) Production day. The term "production day" means—

(i) any day during which natural gas is produced; and

(ii) any day during which natural gas is not produced if production during such day is prohibited by a requirement of State law or a conservation practice recognized or approved by the State agency having regulatory jurisdiction over the production of natural gas.

(B) 90-day production period. The term "90-day production period" means any period of 90 consecutive calendar days excluding any day during which natural gas is not produced for reasons other than voluntary action of any person with the right to control production of natural gas from such well.

(C) Nonassociated natural gas. The term "nonassociated natural gas" means natural gas which is not produced in association with crude oil.

§ 109, 15 U.S.C. § 3319. CEILING PRICE FOR OTHER CATEGORIES OF NATURAL GAS

(a) APPLICATION. The maximum lawful price computed under subsection (b) shall apply to any first sale of any natural gas delivered during any month, in the case of any natural gas which is not covered by any maximum lawful price under any other section of this subtitle, including—

(1) natural gas produced from any new well not otherwise qualifying for a higher maximum lawful price under this title;

(2) natural gas committed or dedicated to interstate commerce on the day before the date of the enactment of this Act and for which a just and reasonable rate under the Natural Gas Act was not in effect on such date for the first sale of such natural gas;

(3) natural gas which was not committed or dedicated to interstate commerce on the day before the date of the enactment of this Act and which was not subject to an existing contract on such day; and

(4) natural gas produced from the Prudhoe Bay Unit of Alaska and transported through the natural gas transportation system approved under the Alaska Natural Gas Transportation Act of 1976 [15 U.S.C. §§ 719 et seq.].

(b) MAXIMUM LAWFUL PRICE. (1) The maximum lawful price under this section for any month shall be—

(A) $1.45 per million Btu's, in the case of April 1977; and

(B) in the case of any month thereafter, the maximum lawful price, per million Btu's, prescribed under this paragraph for the preceding month multiplied by the monthly equivalent of the annual inflation adustment [adjustment] factor applicable for such month.

(2) Ceiling prices may be increased if just and reasonable. The Commission may, by rule or order, prescribe a maximum lawful ceiling price, applicable to any first sale of any natural gas (or category thereof, as determined by the Commission) otherwise subject to the preceding provisions of this section, if such price is—

(A) higher than the maximum lawful price which would otherwise be applicable under such provisions; and

(B) just and reasonable within the meaning of the Natural Gas Act.

§ 602(a), 15 U.S.C. § 3432(a). EFFECT ON STATE LAWS

(a) Authority to Prescribe Lower Maximum Lawful Prices

Nothing in this chapter shall affect the authority of any State to establish or enforce any maximum lawful price for the first sale of natural gas produced in such State which does not exceed the applicable maximum lawful price, if any, under subchapter I of this chapter.

APPENDIX H

List of Corporations in which
GULF CORPORATION, 100 Percent
Owner of Gulf Oil Corporation,
Parent of the Petitioner
KEWANEE OIL COMPANY,
Is Less Than a 100 Percent Owner.

A/S Jargul

A/S Jargul and Co. K/S

AB Djurgardsberg

Adela Investment Company, S.A.

Allied—General Nuclear Services

Andogas S.A. (Switzerland)

Asia Polymer Corp.

Autobahn-Raststaette Wuerenlos AG

China Gulf Oil Company Limited

Chinhae Chemical Company, Ltd.

Colonial Pipeline Company

Delaware Bay Transportation Company

Det Gronlandske Olieaktieselskab

Dixie Pipeline Company

Emery Joint Venture

Ethyleen Pijpleiding Maatshcappij (Belgium) S.A.

Ethyleen Pijpleiding Maatshcappij (Nederland) B.V.

Explorer Pipeline Company

Forenade Svenska Oljeimportorers AB

Gulf Canada Limited

Gulf Oil Canada Limited Associated Companies

Gulf Oil Corporation Erisa

Gulf Oil Terminals (Ireland) Limited

Gulf Oil Zaire S.A.R.L.
Harshaw—Bryce & Co. Pty. Ltd.
Harshaw—Juarez S.A. de C.V.
Harshaw—Murata Kabushiki Kaisha
Harshaw Galvanotecnia S.A.
Harshaw Quimica Ltda.
Hochtemperatur Reaktorbau GMBH
Insco Holding & Finance Company N.V.
Keydril (Nigeria) Limited
Kuwait Oil Company Limited
Laurel Pipe Line Company
Mainline Pipelines Limited
Mid-Valley Pipeline Company
Midwest Carbide Corporation
North River Energy Company
Oil Shippers Service, Inc.
Oklahoma Nitrogen Company
Paloma Pipe Line Company
Pembroke Capital Company
Pembroke Cracking Company
Petrosil Oil Company Limited
Plastigama, S.A.
Plastijal Sociedad Anonima
Platte Pipeline Company
Pol Transport AB
Pyropower Corporation
Raffinerie de Cressier S.A.
Rio Blanco Oil Shale Partnership
Sarni S.P.A.—Refining

Solvent Refined Coal International, Inc.
Solvo Finanzierungs und Beteiligungs AG
Sunrise International Company Limited
Svensk Petroleum Administration A.B.
Svensk Petroleum Largring Tre A.B.
Svenska Petroleum Forvalting A.B.
Taita Chemical Corporation
Valley Pines Associates
Venezuela Gulf Refining Company
West Texas Gulf Pipe Line Company

83 - 1250

No. 83-A-484

In the Supreme Court of the United States

October Term, 1983

KEWANEE OIL COMPANY,
Petitioner,

vs.

BARBARA HOLMES, EXECUTOR OF THE ESTATE OF ELMER HOLMES; EVELYN WOLKINS; SAM BAIER and BONNIE BAIER, His Wife; JAMES H. TRICE, JR., TRUSTEE; and LaVON THOMPSON HOEFLE,
Respondents.

On Petition for Writ of Certiorari to the Supreme Court, State of Kansas

BRIEF OF RESPONDENTS IN OPPOSITION

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Date: February, 1984

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QUESTION PRESENTED

There is no federal question presented in the Petition for Certiorari. Gulf states the federal question is whether or not the Supreme Court of Kansas may ignore the limitations the Natural Gas Policy Act places on prices the purchaser may pay the producer, and, therefore, the producer may not pay its royalty owners in excess of NGPA prices for old gas, even though "stripper gas" and "new gas" are being sold for higher prices pursuant to NGPA. Respondents believe the only question in this case is lease interpretation and application of "prevailing market rate" to royalties payable, and that no federal question is involved.

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Cases

Other

No. 83-A-484

In the Supreme Court of the United States

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Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT, STATE OF KANSAS

BRIEF OF RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the Supreme Court of Kansas which this court is asked to review is as attached to the Petition for Certiorari, *Holmes, et al. v. Kewanee Oil Co.,* 223 Kan. 554, 664 P.2d 1335 (1983), Appendix 1a-13a. Memorandum decision of the trial court is at Petition Appendix 19a-31a.

NATURE OF THE CASE

Judgment was awarded the six plaintiffs, Barber County, Kansas, royalty owners, by the trial court, amounting to the difference between their royalties for natural gas computed and paid during the five years preceding the filing of the action, based on 1/8th of the proceeds of sale, and the royalties based on 1/8th of the market value of the gas. The Supreme Court of Kansas affirmed.

In addition, the trial court allowed and the Supreme Court affirmed the difference in royalty owners' proceeds of gas sold and market value of the gas sold since filing of the actions.

Gulf questions only the judgment as to the difference in royalties paid and market value since December 1, 1978, the effective date of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. Section 3301 et seq. (Petition for Cert., i, Question Presented.)

The Kansas Supreme Court did not as stated by Gulf, Petition for Cert., page 4, reverse the trial court's grant of prospective relief based on the Section 108 price until deregulation in 1985, but said that the market value finding was "factual in nature and not controlling on future cases because the market might fluctuate." (Petition for Cert., Appendix 12a.) The Kansas Supreme Court did say that future royalties should be based on the highest and best price paid for gas in Barber County, Kansas, whether or not that is the Section 108 stripper price, and with this respondents agree.

STATEMENT OF THE CASE

Kewanee Oil Company being a wholly owned subsidiary of Gulf Oil Corporation, which is a wholly owned subsidiary of Gulf Corporation (Petition for Cert., page 2), petitioner will be hereinafter referred to as "Gulf".

Gulf is the successor to lessees under certain oil and gas leases covering Barber County, Kansas, land, most of which were made in 1936 and 1937 by plaintiffs' predecessors in title. (Petition for Cert., Appendix 20a-22a.) The leases have been perpetuated by production.

Respondents are six (6) individual royalty owners, successors to the original oil and gas lessors.

There were extensive findings of fact and conclusions of law made by the trial court (Appendix to Petition, 19a-31a), all of which were affirmed by the Supreme Court of Kansas, excepting findings and conclusions pertaining to prospective relief, which were modified to the highest and best price paid for gas in the Medicine Lodge area, whether or not stripper price. (See Petition for Cert., Appendix 12a.)

REASONS FOR NOT GRANTING THE WRIT

1. The decision of the Kansas Supreme Court is thorough and thoughtful. However, nowhere does it say, as claimed by Gulf, that Section 108 "stripper price" is determined to be the market value. On the contrary, it says that the highest and best price paid in the Medicine Lodge area is the market value, whether or not that is the Section 108 stripper price. (See Appendix to this brief, excerpts from Kansas Supreme Court opinion as to reasons for affirming trial court's decision, Appendix 1a-2a.)

There is no federal question here, but only the question of interpretation of oil and gas leases and application of the "prevailing market rate" to royalties for which royalty owners were entitled under the leases.

2. Gulf admits:

> "Natural gas leases and sales contracts are, of course, to a large extent creatures of state law, to be interpreted according to state law. (Citing cases.)" (Petition for Cert., page 10.)

Gulf further admits that according to *Mobil Oil Corp. v. FPC,* 463 F.2d 256 (D. C. Cir. 1971):

> ". . . royalty owners were not subject to the FPC's jurisdiction under the Natural Gas Act." (Petition for Cert., page 15.)

Neither does the Natural Gas Policy of 1978 apply to royalty owners. (See FERC letter opinion of August 2, 1979, hereto attached at Appendix 3a.) No "sale" was made by royalty owners in *Mobil v. FPC,* supra, nor was any "sale" made by royalty owners under NGPA. Therefore, terms of neither of those acts apply to payments to be made by producers to royalty owners.

3. Federal law does not as stated by Gulf (Petition, pages 9-10) conflict with the Kansas Supreme Court opinion.

These six royalty owners have made no sale of gas. All of the gas belonged to Gulf. Gulf had the exclusive right under the leases to produce and sell the gas. Royalty owners or landowners are not parties to any gas sales contracts. Whatever price Gulf gets for the gas is up to Gulf and KP&L, the purchaser.

Gulf is obligated under the lease contracts to pay its royalty owners 1/8th of "gross proceeds at the prevailing

market rate." This it has not done and will not do until it pays the judgment allowed - as Gulf says (Pet., p. 9), about "half again" more royalty for the period 1974 on up to date - market value having averaged about 3/16ths of proceeds of sale rather than 1/8th. (See also Pet. App. 29a.)

4. Gulf contends the rate it is permitted by federal regulation to charge puts a ceiling on its royalty obligations. Actually, the process begins at the other end. Royalties to be paid should first be determined according to the lease terms and state law. Under Kansas law, the lessee acquires no interest in the land nor in the gas until it is produced. It acquires, under the lease, the license to produce the gas. It then owns the gas and has the right to sell it. What Gulf pays the royalty owners, in royalties, for the right to produce and sell should be no more concern of the rate makers than cost of pipe and equipment or wages for operating the lease. (See Summers Oil & Gas, Permanent Edition, Volume IA, Section 161; and *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, cert. denied, 439 U.S. 1127.)

5. The following cases cited by Gulf dealt with producer - purchaser contracts for sale of gas - not the interpretation of oil and gas lease contracts for royalty payments:

Arkansas Louisiana Gas Co. v. Hall, 453 U. S. 571 (1981);

California v. Southland Royalty Co., 436 U. S. 519 (1978); and

Northern Natural Gas Co. v. Kansas State Corporation Comm., 372 U. S. 84 (1963).

The Kansas Supreme Court *Matzen* case (Petition for Cert., page 13) is not in any way related to this case, nor was there much similarity in the evidence in trial court. Certainly the hypothetical comparison of rates on Petition, page 14, Note 7, has no bearing on the facts or law applicable in this case.

The recent case of *FERC v. Pennzoil Producing Co.*, 439 U. S. 508, does not support Gulf's position that construction of market value royalty clauses in leases was a matter of federal law. On the contrary, this court cited *Lightcap,* supra, and further held that "all that is protected against, in a constitutional sense, is that the rates fixed by the Commission be higher than a confiscatory level." (*FERC v. Pennzoil,* supra, page 519.)

6. In October, 1981, the Gulf (Kewanee) - KP&L contract price was $2.08 per million btu's (per 1,000 cubic feet) as compared to $3.116 paid on Medicine Lodge area stripper well gas - half again as much. (Petition for Cert., page 9.) This would mean a royalty payment of 3/16ths rather than 1/8th - a royalty amount for which most new leases in the area are being written - hardly confiscatory as argued by Gulf. (Petition, page 14.) After more than 40 years production while paying a royalty of only 1/8th of contract proceeds, Gulf can now well afford to pay a 3/16ths royalty. Cost of their wells now has been paid many times over.

7. The Kansas Supreme Court was not ruling what the purchase price should be under the contract, but what amount of royalty the producer should pay under terms of the leases.

The judgment is not a windfall for the lessors, but payment to which they are entitled under the plain, simple and specific terms of the leases.

The Kansas Supreme Court opinion ruling does not affect the gas purchase contract but only the proportion of the amount of gas sales that goes to the royalty owners.

There was no ruling on federal law or the purchase price of gas but only a ruling as to the amount of royalties payable under terms of the leases.

8. Gulf argues that Kansas stands alone in holding that market value royalty payments may exceed federally regulated contract gas prices. Not so. Both Montana and Texas, substantial gas producing states, stand with Kansas. (*Montana Power Co. v. Kravik,* 586 P.2d 298 (Montana 1978); *Texas Oil & Gas Corp. v. Vela,* 429 S.W. 2d 866 (Texas 1968); *Foster v. Atlantic Refining Co.,* 329 F.2d 485 (5th Cir. 1964); and *Exxon Corp. v. Middleton,* 613 S.W.2d 240 (Texas 1981).)

9. Market value is defined as the price at which the owner of the goods or the producer holds them for sale; the price at which they are freely offered in the market to all the world. (*Muser v. Magone,* 155 U. S. 240.) On the other hand, the regulated price for natural gas constitutes a utility rate which is designed to compensate the producer's actual cost of producing, gathering, transporting and marketing the natural gas, and afford it a fair return on its investment. (*Lightcap,* supra.) This rate does not purport to reflect the value of gas as determined in a market between willing buyers and sellers. (*Huber Corp. v. Denman,* 367 F.2d 104 (5th Cir. 1966).)

The fact that federal regulations restrict the price at which the lessee could have sold the gas in a free market should not change the meaning that a state court gives to "prevailing market rate" or the meaning that the parties undoubtedly gave to the term in 1936 and

1937 when the leases were made (long before the Natural Gas Act or the Natural Gas Policy Act). Neither should the regulated prices for sales constitute an artificial market for purposes of determining the lessor's royalty rights, since such rights are excluded from gas regulation. (*Mobil Oil Corp. v. Federal Power Commission,* 463 F.2d 256 (D. C. Cir. 1971), cert. denied, 406 U. S. 976, 92 S. Ct. 2409, 32 L. Ed. 2d 676; and FERC letter opinion of 8-2-79 attached, Appendix 3a.)

Petitioner would fashion a rule that modifies the contractual relation between the parties and would abrogate parties' express intention to the contrary. When the parties executed the leases in 1936 and 1937 neither reasonably foresaw federal regulation of natural gas prices. Presumably, their choice of a royalty clause based on the market rate or value of the gas anticipated a continuation of a market in which the price is determined by the law of supply and demand for the commodity and the highest and best prices paid in a particular area for comparable natural gas.

To hold as requested by Gulf would constitute judicial tampering with the clear provisions of the oil and gas lease contracts and would impose price ceilings on royalty payments - something never intended by Congress.

CONCLUSIONS

1. The Kansas Supreme Court has determined "prevailing market rate" to be the highest and best price paid producers for comparable natural gas in the Medicine Lodge area, at the time of production.

2. Gulf admits that oil and gas leases are to be interpreted according to state law and that royalty owners are not subject to FERC jurisdiction.

3. Federal law - the Natural Gas Policy Act - set ceiling prices that purchasers may pay producers - not ceilings on amounts that producers may pay their royalty owners.

4. Royalty owners have made no "sales" under NGPA. Sales contracts are between producers and gas purchasers, and royalties paid are only part of the costs of production. After the decision in *Mobil v. FPC,* supra, holding royalty owners not subject to FPC jurisdiction, Congress, in 1978, had it so intended, would have defined royalty owners subject to NGPA. It did not do so, and, as stated in FERC letter, Appendix 3a, royalty payments are a matter of state law.

5. Cases cited by Gulf are not authority for this court to interfere with contractual rights of royalty owners under oil and gas leases, as established by a State Supreme Court.

6. The Kansas Supreme Court's decision increases royalties payable from 1/8th or 2/16ths of proceeds of sale of gas to about 3/16ths, leaving Gulf or working interest owners about 13/16ths of total production.

7. The Kansas Supreme Court does not attempt to rule on NGPA or its effect but only on market value

of royalties payable under terms of Kansas oil and gas leases.

8. This case involves interpretation and application to royalty payments of a rather unusual phrase "prevailing market rate," in a few old, Barber County, Kansas, oil and gas leases.

9. NGPA does not attempt to control percentage of proceeds of sale of natural gas payable by a producer to its royalty owners.

10. This Court should not tamper with plain, simple and specific terms of oil and gas lease contracts and attempt to increase Gulf's profits by imposing ceilings on its royalty obligations.

11. The Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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P. O. Box 148
Medicine Lodge, Kansas 67104
Attorneys for Respondents

February, 1984

APPENDIX

EXCERPTS FROM KANSAS SUPREME COURT OPINION - REASONS FOR AFFIRMING TRIAL COURT'S DECISION

". . . the basic question is the propriety of the trial court's interpretation of the phrase in the leases 'prevailing market rate.'" (Pet. Appendix 4a.)

"In. . . *Lightcap v. Mobil Oil Corporation,* 221 Kan. 448, 562 P.2d 1, cert. denied 434 U. S. 876 (1977) gas royalties to be calculated on the basis of market value or market price at the well, refers to value or price at the current market rate prevailing when the gas is delivered rather than the proceeds or amount realized under a gas purchase contract. . . The court stated market value or price could exceed the amount fixed by federal regulations under the Natural Gas Act of 1938. (15 U.S.C. Section 717 et seq.)" (Pet. Appendix 6a.)

"As he testified at trial Myers (a consulting petroleum engineer and expert witness for the lessors) believed the highest price being paid for gas in Kansas after enactment of the NGPA was the NGPA Section 108 (stripper well) price. 15 U.S.C. Section 3318." (Pet. Appendix 8a.)

"More important, however, is the principle of *Lightcap* that market value is the issue, irrespective of whether the sale is interstate or intrastate. See 3A Summers, *The Law of Oil & Gas,* Section 589 (1983 Supplement)." (Petition Appendix 8a.)

"The second determination pertained to the period after 1978 when intrastate gas became subject to federal regulation. Since there were no unregulated sales at the

time that determination was based on the highest regulated price for comparable natural gas in Barber County." (Pet. Appendix 10a.)

"Here the trial court relied on evidence of 'comparable sales' as the basis of its decision. Comparable sales of gas are those comparable in time, quality, quantity and availability of marketing outlets." (Pet. Appendix 10a.)

"Thus, as we noted at the outset, our task is to determine whether the trial court's findings regarding market value and comparable sales are supported by substantial, competent evidence." (Pet. Appendix 11a.)

"Based on the testimony of Mr. Myers, it simply used the highest price paid for comparable gas in the area both before and after federal regulation of interstate gas. As noted above those prices were obtained from the Okmar contract prior to 1978 and the NGPA Section 108 price after 1978. In both instances Myers testified the product for sale was comparable as to physical quality and access to market." (Pet. Appendix 11a.)

"The lessee thus has the opportunity to protect itself through specific terminology in the lease. In the absence of any evidence of contrary intent of the parties, we conclude the lessors are entitled to royalties based on the market value of gas at the time of production." (Pet. Appendix 11a-12a.)

"Although the use of the NGPA Section 108 price may be confusing it is used merely as evidence the gas is worth more than the Section 105 price placed on it by the FERC. Just as they were not bound by the gas purchase price, royalty owners with a market value lease are not limited to the regulated price." (Pet. Appendix 12a.)

Natural Gas Policy Act
Information Service

¶ 4,220 p.1

¶ 4,220 LETTER OPINION (OGC) - SECTION 2(21)
Alamo Petroleum Company
August 2, 1979

FEDERAL ENERGY REGULATORY COMMISSION

August 02, 1979

Mr. Paul F. Vandergriff
Vice President - Land
Alamo Petroleum Company
4925 Greenville Avenue
Dallas, Texas 75206

Dear Mr. Vandergriff:

This is in reply to your letter dated May 23, 1979, requesting the General Counsel's interpretation of certain provisions of the Natural Gas Policy Act of 1978 (NGPA).

You have asked questions concerning the payment of royalty interests in accordance with the terms of a gas balancing agreement and the provisions of the subject leases. The NGPA Title I pricing scheme applies only to "first sale" transactions and not to those royalty payments which do not involve a transfer of gas for value. *Thus, an interpretation of the agreements with respect to royalty payments would appear to be a matter of State law.*

I hope the foregoing is responsive to your questions. The views contained herein are mine and do not bind the Commission in any way.

Sincerely,

Robert R. Nordhaus
General Counsel

(4)

No. 83-1250

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

KEWANEE OIL COMPANY,

Petitioner,

v.

BARBARA HOLMES, Executor of the Estate of Elmer Holmes; EVELYN WOLKINS; and SAM BAIER, *et al.*,

Respondents.

On Petition for a Writ of Certiorari to The Supreme Court of the State of Kansas

MOTION TO DEFER CONSIDERATION OF PETITION FOR A WRIT OF CERTIORARI

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6 pp.

TABLE OF AUTHORITIES

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On Petition for a Writ of Certiorari to The Supreme Court of the State of Kansas

---

MOTION TO DEFER CONSIDERATION OF PETITION FOR A WRIT OF CERTIORARI

Petitioner Kewanee Oil Company[1] moves to defer consideration of the petition in this case until the petitions in *Ashland Oil, Inc.* v. *Good,* No. 83-1234; *Mobil Oil Corp.* v. *Batchelder,* No. 83-1248; and *Cities Serv. Oil Co.* v. *Matzen,* No. 83-1278, are considered. As indicated by their numbers, those petitions were filed at about the same time as this one. But the respondents in those cases have asked for and been granted an extension of time

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[1] Kewanee is a subsidiary of Gulf Oil Corporation, which in turn is a wholly owned subsidiary of Gulf Corporation. Gulf's non-wholly owned subsidiaries and affiliates were listed in Appendix H of Kewanee's petition for certiorari.

until April 6, 1984, in which to file a brief in opposition. The brief in opposition to Kewanee's petition has been filed and this case is therefore ripe for consideration.

The petitions in Nos. 83-1234, 83-1248 and 83-1278 all seek review of the same decision of the Kansas Supreme Court, reported as *Matzen* v. *Cities Serv. Oil Co.*, 233 Kan. 846, 667 P.2d 333 (1983). Kewanee's petition asks for review of a different decision of the Kansas Supreme Court, *Holmes* v. *Kewanee Oil Co.*, 233 Kan. 544, 664 P.2d 1335 (1983). The parties and the facts in the two cases are different, but the issues are analytically the same or very nearly the same.

The *Matzen* petitioners are producers of natural gas that sold their gas to interstate customers and thus were subject to the price constraints imposed by the Federal Power Commission and its successor, the Federal Energy Regulatory Commission, under the Natural Gas Act. The Kansas court held that these producers were bound to make royalty payments to their lessor/landowners equal to a fraction of the maximum price for "new" gas prescribed by the FPC and the FERC even though their gas was "old" gas subject to a lower federal ceiling. Petitioners assert, *inter alia*, the inconsistency of that ruling with the Natural Gas Act, the Supremacy Clause, and the Commerce Clause.

This case concerns intrastate sales of gas made by petitioner Kewanee after the enactment in 1978 of the Natural Gas Policy Act, the successor to the Natural Gas Act, which extended federal rate regulation to such intrastate sales. The Kansas court ruled that Kewanee must make royalty payments to its lessor/landowners equal to a fraction of a statutory incentive price for gas from low-production wells (which Kewanee's wells were not) that is significantly higher than the price Kewanee

was permitted by the Natural Gas Policy Act to charge for its gas. Petitioner asserts that this ruling is inconsistent with the Natural Gas Policy Act and the Supremacy Clause.

The similarity of the issues in the cases, obvious we hope from the foregoing description, is recognized in the petitions: Kewanee's petition describes the two cases as presenting variants of the same basic question (p. 13); Ashland's petition in No. 83-1234 describes the cases as companion cases (p. 18); and Mobil's petition in No. 83-1248 speaks of them as taking the same "basic approach" (p. 25 n.32). Furthermore, the American Petroleum Institute and other organizations have just filed a brief amici curiae supporting in a single document the four petitions to review the two Kansas decisions. And we are given to understand that the Solicitor General will soon file on behalf of the FERC a brief amicus curiae in the *Matzen* cases in which he will suggest that the Kewanee petition ought also to be granted and the case heard together with the *Matzen* cases or that this case should be held to await the outcome of the others.

It is clear enough that this case involves more than merely the "interpretation and application to royalty payments of a rather unusual phase 'prevailing market rate,' in a few old, Barber County, Kansas, oil and gas leases." (Br. in Opp. 10.) The respondents would like it so, but both here and in the related *Matzen* case the Kansas

Supreme Court has exceeded the limits imposed by supreme federal law in stretching to read that lease term to favor Kansas landowners. The two cases should be considered together.

Respectfully submitted,

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March 1984

No. 83-1250

In the Supreme Court of the United States

October Term, 1983

KEWANEE OIL COMPANY,
Petitioner,

vs.

BARBARA HOLMES, Executor of the Estate of Elmer Holmes; EVELYN WOLKINS; SAM BAIER and BONNIE BAIER, His Wife; JAMES H. TRICE, JR., Trustee; and LAVON THOMPSON HOEFLE,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF KANSAS

BRIEF IN OPPOSITION TO BRIEF AMICI CURIAE OF AMERICAN PETROLEUM INSTITUTE, et al.

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No 83-1250

In the Supreme Court of the United States

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KEWANEE OIL COMPANY,
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Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF THE STATE OF KANSAS

BRIEF IN OPPOSITION TO BRIEF AMICI CURIAE OF AMERICAN PETROLEUM INSTITUTE, et al.

FACTS

The American Petroleum Institute, the Kansas Independent Oil & Gas Association, the Mid-Continent Oil & Gas Association, the Rocky Mountain Oil & Gas Association and the Western Oil & Gas Association have filed brief in this small case combining it with brief in No. 83-1234, *Ashland Oil v. Good, et al.;* No. 83-1248, *Mobil Oil v. Batchelder, et al.;* and No. 83-1278, *Cities Service Oil v. Matzen, et al.*

The Solicitor General has filed Amicus Curiae Brief in the three cases last mentioned and not in this case, but on Page 7 of that brief the Solicitor General submits that this Court should either grant the petition in *Kewanee* together with petitions in the three cases and set the cases

for argument in tandem, or should defer disposition of the *Kewanee* petition pending the outcome of these three cases last mentioned.

Motion was made by petitioner, Kewanee, in March, 1984, to defer consideration of Petition for Writ of Certiorari in this case until petitions in the three cases last mentioned have been considered. Order has not been made on Motion to Defer, but neither has order been made denying or granting certiorari in this case.

Meanwhile, consideration of the three cases last above mentioned has been deferred pending settlement approval by the District Court in Kansas of settlements made by the parties, approximately $50,000,000.00 in the Mobil Oil class action, $15,000,000.00 in the Ashland Oil class action and $35,000,000.00 in the other class actions.

The present case, the *Kewanee* (*Gulf*) case is not a class action but three separate actions by Barber County, Kansas, royalty owners involving ten oil and gas leases made in 1929 to 1936 covering a contiguous area in one township. (See Petition for Cert., Pages 20a-21a.) Three cases were consoldiated for trial in District Court and for appeal to the Supreme Court of Kansas.

Of the $272,391.68 judgment originally involved (Petition for Cert., Page 3a) only the amount involved from December 1, 1978, to date of judgment (November 1, 1981) is involved in this Petition for Cert. and that amount is $87,292.25. (See Exhibit "A" hereto attached.)

We have just been informed that the multi-million dollar settlements made in the three other cases have been approved by the District Courts in Kansas. Consequently, we assume that the pending Petition for Cert. in those three cases, *Mobil Oil, Ashland Oil,* and *Cities Service, et al.*, will be dismissed.

ARGUMENT

Amici, in their brief, assume facts not in evidence and not true, i.e.: (1) a 3/16ths royalty rather than 2/16ths would increase costs to the consumer; and/or (2) for producer to bear the additional 1/16th cost would eliminate incentive for maximum production.

Gulf's net profits exceed $5,000,000.00 per day (1982 annual report). The decrease in net profits caused by this case (less than $2,500.00 per month) would not even be noticed.

In one of the amicus briefs the case of *Silkwood v. Kerr-McGee Corp.*, No. 81-259, January 11, 1984, was quoted to the effect that:

> "It is well settled that state action is invalid under the Supremacy Clause if it 'stands as an obstacle to the accomplishment of the full purposes and objectives of Congress'."

However, the general holding of the case was that state action is not invalid (particularly as to punitive damages) when it is not an obstacle to the accomplishment of the full purposes and objectives of Congress.

The same is true in this case. Congress, in NGPA, had no intention of controlling the amount of royalty payments that producers may make to their lessors or royalty owners.

In fact, most leases being written in the Barber County, Kansas, area at the present time are being written for royalties in excess of the old 1/8th or 12 1/2%.

Admittedly (Petition for Cert., Page 9), Gulf's royalty owner obligation under Kansas Supreme Court decision would increase 1/2 or to 3/16th rather than 2/16th or 1/8th. This still would leave Gulf substantial profit from the operation of their leases, 82.5% rather than 87.5% of total proceeds of sale. Hardly confiscatory. Undoubtedly not requiring a "drastically increased price" to the consumer as argued in the FERC Amicus Brief, Page 10, or to "eliminate incentive for continued maximum production" (same page) on account of less profit.

The increased royalty payments in these cases, the amount that is being paid for comparable gas from a comparable area in interstate commerce or intrastate commerce, would not decrease Gulf's net profits substantially. Gulf and its predecessor producers have received millions of dollars from their 7/8th share of gas produced over the last 30 to 40 years.

Amici contend that the case of *Arkansas Louisiana Gas Co. v. Hall,* 101 S. Ct. 2925 (1981), 453 U. S. 571 (*Arkla*) supports their position. Not so. *Arkla* was a case between a natural gas producer and an interstate pipeline. This case is by landowner lessors, royalty owners, against the gas producer, the lessee, based on terms of the oil and gas lease. This is clearly a matter for decision under state law, not federal law. A divided court, in *Arkla,* held that the "filed rate doctrine" prevailed and that damages constituting payment for more than the amount of filed rate could not be allowed. *Arkla* is far different than allowing royalty owners prevailing market rate according to their oil and gas leases.

Now that the cases involving millions of dollars have been settled and certiorari will not be granted, certiorari

should be denied on this little case involving interpretation of landowners' royalty rates.

Respectfully submitted,

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Date: August, 1984

EXHIBIT "A"

	Total Judgment 1-7-82 (Pet. 15a)	Accumulated Prior to 12-1-78	Amount Appealed from 12-1-78 to 11-1-81 (Pl. Ex. 1)
Case No. 77C46			
Holmes "D"			
Barbara Holmes	38,435.00	38,435.00	–0–
Case No. 77C56			
Holmes "D"			
Evelyn Wolkins	27,727.00	–0–	27,727.00
Barbara Holmes	39.00	39.00	–0–
B. E. Holmes Lease			
Barbara Holmes	1,102.00	1,102.00	–0–
Evelyn Wolkins	69.00	69.00	27,727.00
Case No. 78C19			
J. C. McKee Lease			
Sam & Bonnie Baier	112,823.00	63,962.00	48,861.00
U. L. Thompson "A"			
LaVon Hoefle	37,344.00	28,352.75	8,991.25
U. L. Thompson "B", "C" and "D"			
LaVon Hoefle	48,161.00	21,734.33	26,426.67
J. H. Trice "E"			
James H. Trice, Trustee	2,290.00	1,033.00	1,257.00
LaVon Hoefle	1,526.00	687.14	838.86
Trice-Thompson Lease			
James H. Trice, Trustee	1,224.00	831.50	392.50
LaVon Hoefle	1,632.00	1,107.03	524.97
	272,372.00		87,292.25

③ ③ ③ ②

Nos. 83-1234, 83-1248, 83-1250, and 83-1278

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

ASHLAND OIL, INC., *et al.*,
Petitioners,

v.

FRANK GOOD, *et al.*,
Respondents.

KEWANEE OIL COMPANY,
Petitioner,

v.

BARBARA HOLMES, *et al.*,
Respondents.

On Petitions for Writs of Certiorari to the Supreme Court of the State of Kansas

---

BRIEF *AMICI CURIAE* OF AMERICAN PETROLEUM INSTITUTE, KANSAS INDEPENDENT OIL AND GAS ASSOCIATION, MID-CONTINENT OIL AND GAS ASSOCIATION, ROCKY MOUNTAIN OIL AND GAS ASSOCIATION, AND WESTERN OIL AND GAS ASSOCIATION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

Nos. 83-1234, 83-1248, and 83-1278

ASHLAND OIL, INC., *et al.*,
Petitioners,

v.

FRANK GOOD, *et al.*,
Respondents.

No. 83-1250

KEWANEE OIL COMPANY,
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BARBARA HOLMES, *et al.*,
Respondents.

On Petitions for Writs of Certiorari to the Supreme Court of the State of Kansas

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BRIEF *AMICI CURIAE* OF AMERICAN PETROLEUM INSTITUTE, KANSAS INDEPENDENT OIL AND GAS ASSOCIATION, MID-CONTINENT OIL AND GAS ASSOCIATION, ROCKY MOUNTAIN OIL AND GAS ASSOCIATION, AND WESTERN OIL AND GAS ASSOCIATION

The American Petroleum Institute, the Kansas Independent Oil and Gas Association, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association submit this brief as *amici curiae* in support of the petitions for writs of certiorari in Nos. 83-1234, 83-1248, 83-1250, and 83-1278.[1] The petitions seek review of two separate judgments of the Supreme Court of the State of Kansas. That Court held in both cases that, under leases containing "market value" royalty clauses, natural gas producers must pay royalties to Kansas landowners based on an imputed value of the gas that substantially exceeds the maximum price the producers were permitted to charge under federal law.

Amici believe that both judgments are incompatible with the uniform and comprehensive federal scheme of natural gas price regulation and are barred by the Supremacy Clause. The petitions present recurring questions of substantial public importance warranting plenary review by this Court.

INTERESTS OF THE *AMICI CURIAE*

Each of the *amici* is a petroleum industry trade association whose members include producers of natural gas. Those members are affected either directly or indirectly by the Kansas decisions imposing increased royalty obligations on natural gas producers under "market value" royalty clauses. They therefore have a vital interest in the issues presented by the petitions for certiorari in these cases.

The American Petroleum Institute ("API") represents approximately 315 member companies and 8,000 individual members. API's members are engaged in all facets of the petroleum industry, including the production and

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[1] **All parties have consented in writing to the filing of this brief. Copies of letters from counsel have been lodged with the Clerk.**

marketing of natural gas throughout the United States, in both interstate and intrastate commerce. API represents the interests of its members before government agencies, in Congress, and in the courts. It appears frequently as a party or as *amicus curiae* in cases affecting the petroleum industry, including cases in this Court.

The Kansas Independent Oil and Gas Association was formed in 1938 to serve the interests of independent oil and gas producers and supporting industries in Kansas. It has approximately 1,300 members. The Association has previously appeared as *amicus curiae* on behalf of its members in court cases involving industry-wide issues.

The Mid-Continent Oil and Gas Association is a voluntary, unincorporated organization of approximately 7,200 individuals devoted to advancing the oil and gas industry in Oklahoma, Kansas, Texas, Louisiana, Mississippi, and Alabama. The Association and its four divisions are concerned with legislative and regulatory matters of interest to the industry on both federal and state levels. It disseminates information to its members and represents the industry before legislative bodies, government agencies, and courts.

The Rocky Mountain Oil and Gas Association was founded in 1920 and today represents approximately 650 companies doing business in Colorado, Idaho, Montana, Nebraska, North Dakota, South Dakota, Utah, and Wyoming. The Association promotes the development, production, and marketing of oil and gas in the Rocky Mountain region. It appears as a party or as *amicus curiae* on behalf of its members in court cases involving issues of importance to the petroleum industry.

The Western Oil and Gas Association represents nearly 100 member companies that conduct much of the production, refining, and marketing of petroleum and petroleum products in the western United States. The Association's purpose is to promote and foster through cooperative

effort the interests of all branches of the western oil and gas industry. It participates frequently as a party or as *amicus curiae* in litigation affecting the interests of its members.

ARGUMENT

The Ashland, Mobil, and Cities Service petitions involve claims by Kansas landowners seeking additional royalties from natural gas producers for gas sold in the federally regulated interstate market between 1961 and 1978. The leases required the producers to pay fractional royalties based on the "market value" of the gas sold. Although the producers could not lawfully sell the gas at a price higher than the maximum permitted by the Federal Power Commission (and its successor, the Federal Energy Regulatory Commission) under the Natural Gas Act, the Kansas Supreme Court held that the applicable federal ceiling price "is not an obstacle to the fixing of a higher rate as the 'market value' . . . for the purpose of computing royalties." Ashland Pet. App. 13a.

The Kewanee petition involves similar claims for additional royalties for gas sold in the intrastate market between 1978 and 1981, a period during which such sales were subject to federal ceiling prices imposed under the Natural Gas Policy Act. In that case, too, the Kansas Supreme Court held that "royalty owners with a market value lease are not limited to the regulated price." Kewanee Pet. App. 12a. The Court ruled that the producer must pay royalties based not on the highest price it could lawfully charge for the category of gas it sold, but on the highest price paid during the relevant period for any category of natural gas sold in the producing area. *Id.* at 7a-8a, 11a-12a.

1. The Kansas rulings impermissibly invade the exclusively federal domain of natural gas price regulation. Congress "impose[d] a comprehensive regulatory system on the transportation, production, and sale" of natural

gas. *FPC v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1, 28 (1961). Where "Congress has so plainly occupied the regulatory field," any state action that creates a "danger of interference with the federal regulatory scheme" "must be declared a nullity." *Northern Natural Gas Co. v. State Corporation Comm'n*, 372 U.S. 84, 92, 93 (1963). The Kansas decisions at issue here present more than a "danger" of interference; they unavoidably clash with the federal rate scheme. The rulings are therefore invalid under the Supremacy Clause because they "stan[d] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

The "fundamental purpose" of natural gas regulation "is to assure an adequate and reliable supply of gas at reasonable prices." *California v. Southland Royalty Co.*, 436 U.S. 519, 523 (1978). Supply and price, of course, are inextricably linked. In establishing maximum producer rates for interstate sales, the FPC accordingly followed a cost-based approach but included non-cost elements designed "to encourage the production of appropriate supplies of natural gas." *Permian Basin Area Rate Cases*, 390 U.S. 747, 796 (1968); *see also Mobil Oil Corp. v. FPC*, 417 U.S. 283, 320 (1974). The resulting rate structure was thus intended to provide a fair return to producers and an incentive for "satisfactory programs of exploration, development and production." *Permian Basin*, 390 U.S. at 796.

Royalty costs were a significant component of the FPC's rate determinations. For the producing area involved here, the Commission included in its rate calculation a royalty cost factor of 14 percent of the ceiling prices. *See Area Rate Proceeding (Hugoton-Anadarko Area)*, 44 F.P.C. 761, 904, 908 (1970), *aff'd sub nom. In re Hugoton-Anadarko Area Rate Case*, 466 F.2d 974 (9th Cir. 1972). The Kansas Supreme Court ruled, however, that royalties must be paid on the basis of a ficti-

tious market value for the gas far in excess of the applicable ceiling prices. The effect of its decisions is to impose massive retroactive increases in producer royalty costs that amount, for example, to approximately 60 percent of the federal ceiling prices for interstate sales instead of the 14 percent that the FPC had assumed. *See* Ashland Pet. 15; Mobil Pet. 8 & n.12; Cities Service Pet. 7.

The Kansas decisions will consequently disrupt the federal rate scheme and interfere with fulfillment of the Congressional purposes. The burden of increased royalty payments to Kansas landowners will have to be borne either by the producers themselves or by natural gas consumers. Neither result is consistent with the federally established rate structure. If producers are forced to absorb the costs, they will suffer a reduced rate of return, below that found to be reasonable by the FPC and FERC. They will also have fewer funds for investment in "programs of exploration, development and production" (*Permian Basin*, 390 U.S. at 796), contrary to the Commission's supply objectives. Alternatively, if the FERC were to grant rate relief to the producers, as the Kansas Supreme Court invited it to do (Ashland Pet. App. 16a-20a), then the cost of the increased royalty payments would be shouldered by natural gas consumers, contrary to the Commission's price objectives. Indeed, since reduced supply leads over time to increased price, consumers will bear the long-term consequences of the Kansas decisions regardless of how the short-term costs are allocated.

The circumstances here are analogous to those in *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571 (1981) ("*Arkla*"), where this Court invalidated a Louisiana state court award of damages in a breach of contract action brought by a natural gas producer against a pipeline customer. The pipeline had failed to pay a higher price called for under a contingency clause of the con-

tract, and the court awarded damages measured by the difference between the price actually paid and the price that should have been paid. Although both prices were below the applicable federal ceiling, only the lower price had been filed by the producer with the FPC. Under the "filed rate doctrine," a producer may not collect a rate higher than that filed with the Commission.

This Court rejected the producer's claim that "[n]o federal interests" were implicated by an award of contractual damages under state law. *Id.* at 579. It held that the state court had in effect retroactively "award[ed] as damages a rate never filed with the Commission and thus never found to be reasonable within the meaning of the Act." *Id.* The state court judgment consequently "undermine[d] the congressional scheme of uniform rate regulation" and "usurped a function that Congress has assigned to a federal regulatory body." *Id.* at 579, 582. The Court agreed with the Commission that "permitting this damages award could have an 'unsettling effect . . . on other gas purchase transactions' and would have a 'potential for disruption of natural gas markets . . . .' " *Id.* at 579.

The principles of *Arkla* apply with even greater force to this case. Although the Kansas rulings do not directly alter producer rates retroactively, their indirect effect is no less pernicious. The imposition of tens of millions of dollars in increased royalty costs for producers nullifies the cost assumptions underlying the federal rate structure and, as we have shown, unavoidably subverts that structure. Either the supply objective or the price component, or both, will be compromised. Unlike the situation in *Arkla*, moreover, the state court decisions here will affect not merely the "filed rate" but the maximum lawful price. The result here thus holds far greater " 'potential for disruption of natural gas markets' " and even more clearly "undermine[s] the congressional scheme of uniform rate regulation." *Id.* at 579.

These principles hold no less in the context of the Natural Gas Policy Act than in that of the Natural Gas Act, under which *Arkla* was decided. Although the price ceilings established by Congress in the NGPA are not strictly cost-based, *Public Service Comm'n v. Mid-Louisiana Gas Co.*, 103 S. Ct. 3024, 3032 (1983), they are deemed "just and reasonable," as were the Commission-set Natural Gas Act rates. *Id.* at 3033; NGPA § 601 (b) (1) (A), 15 U.S.C. § 3431(b) (1) (A). The NGPA's elaborate structure of price ceilings represents a Congressional balancing of producer supply incentives and consumer cost protection. *See* Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 Tex. L. Rev. 101 (1980). The Kansas court's disregard of the applicable federal ceiling price in royalty determinations upsets the legislative balance under the NGPA just as it disturbs the rate structure under the predecessor Natural Gas Act.

That the royalty clause rulings operate indirectly rather than directly does not insulate them from the Supremacy Clause. As this Court held when Kansas once before ventured too far, "[t]he federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas, . . . or for state regulations which would indirectly achieve the same result." *Northern Natural Gas Co. v. State Corporation Comm'n*, 372 U.S. at 91.

Nor can the Kansas Supreme Court's action here escape scrutiny under the Supremacy Clause on the theory that the Court merely applied state contract law. Private parties are not "free to make arrangements that would circumvent the ratemaking and supply goals of the statute," *California v. Southland Royalty Co.*, 436 U.S. at 526, and state courts are not free to fabricate or enforce such arrangements by resort to principles of state law. "A regulatory statute such as the Natural Gas Act

would be hamstrung if it were tied down to technical concepts of local law." *United Gas Improvement Co. v. Continental Oil Co.*, 381 U.S. 392, 400 (1965). Thus, as in *Arkla*, "the mere fact that respondents brought this suit under state law would not rescue it, for when Congress has established an exclusive form of regulation, 'there can be no divided authority over interstate commerce.' " 453 U.S. at 580.

It is no answer to say, as the Kansas Supreme Court implied, that the royalty clause rulings can be harmonized with federal objectives if the FERC allows appropriate rate adjustments for affected producers. "Not the federal but the state regulation must be subordinated, when Congress has so plainly occupied the regulatory field." *Northern Natural Gas Co. v. State Corporation Comm'n*, 372 U.S. at 93. "The FERC need not adjust its ruling to accommodate" a state law; "[t]o the contrary, the State may not trespass on the authority of the federal agency." *Maryland v. Louisiana*, 451 U.S. 725, 751 (1981).

2. Kansas is the only State that has imputed a market value for royalty purposes in excess of the federal ceiling price for regulated gas. As each of the petitions for certiorari points out, the United States Court of Appeals for the Fifth Circuit and the highest courts of Texas, Louisiana, Arkansas, and Oklahoma, in applying "market value" royalty clauses, have all properly avoided a conflict with the overriding federal scheme of natural gas price regulation. *See* Ashland Pet. 13-14; Mobil Pet. 19-20; Cities Service Pet. 14-15; Kewanee Pet. 16-17.

The decisions here, if allowed to stand, will therefore have anomalous consequences. A producer operating in both Kansas and a neighboring State under leases containing identical royalty clauses will nevertheless be required to pay dramatically higher royalties to Kansas landowners than to those in the sister State for sales of gas in the same federal price category. Producers in Kansas, moreover, may be competitively disadvantaged

in comparison with similarly situated producers in Texas or Oklahoma who are not burdened by increased royalty obligations. Consumers may be forced to pay a higher price for gas produced in Kansas than for gas produced in another State, merely because of the differing state court holdings on "market value" royalty clauses. Finally, the FERC will have to consider making geographically discrete rate relief adjustments to accommodate the unique royalty determinations of the Kansas Supreme Court.

These results are at war with the FPC's and FERC's efforts "to achieve the uniformity of regulation which was an objective of the Natural Gas Act." *Northern Natural Gas Co. v. State Corporation Comm'n*, 372 U.S. at 91-92. If the Kansas decisions are left undisturbed, "the scope of federal regulatory power would vary in accordance with the kaleidoscopic variations of local contract law" (*id.* at 98), a result plainly foreclosed by the Supremacy Clause.

3. The questions presented here are of substantial national importance. Kansas is the Nation's fifth largest gas producing State. *See* Energy Information Administration, *Producer Revenues, Prices, and Concentration in the Natural Gas Market* 11 (Nov. 1983). Gas produced in Kansas is sold to major pipelines serving customers in the mid-continent, the upper midwest, and elsewhere. The supply and price consequences of the Kansas Supreme Court's decisions will therefore be felt far beyond the Kansas borders.

"Market value" royalty clauses, moreover, are commonly found in mineral leases in all areas of the country, and litigation over the application of such clauses has been going on in most of the gas producing States for more than a decade. Although the courts in most of the States had determined that "market value" is limited by the applicable federal ceiling price (or by the price re-

ceived under the producer's contracts with its customers), the Kansas decisions, if left in place, may ignite a fresh round of judicial or legislative efforts to secure for the landowners in other States the benefits provided to Kansas landowners by the Kansas Supreme Court. The issues therefore have continuing importance for producers, pipeline companies, and natural gas consumers nationwide.

The Kansas rulings puncture a large hole in the fabric of federal natural gas regulation. They seriously impair the capacity of the FERC to assure uniform and effective regulation of the price and supply of natural gas. Whether a state court may apply "market value" royalty clauses in this manner without invalidly encroaching upon the federal regulatory jurisdiction warrants this Court's plenary consideration.

CONCLUSION

The petitions for writs of certiorari should be granted.

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FEBRUARY 1984